TREATMENT OF LIFO RECAPTURE AND FEDERAL NATIONAL MORTGAGE ASSOCIATION NET OPERATING LOSSES

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

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TREATMENT OF LIFO RECAPTURE AND FEDERAL NATIONAL MORTGAGE ASSOCIATION NET OPERATING LOSSES

WEDNESDAY, DECEMBER 9, 1981

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 10:20 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Press release announcing hearing follows:]

[Press release of Nov. 18, 1981]

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A 1-DAY PUBLIC HEARING ON LIFO RECAPTURE AND THE TREATMENT OF NET OPERATING LOSSES OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced a one-day public hearing on H.R. 4717 (Mr. Jenkins) and H.R. 5011 (Mr. Gradison), to further defer the effective date of certain provisions providing for the recognition as income of LIFO inventory reserves; and H.R. 5013 (Mr. Rostenkowski, for himself and Mr. Conable), to conform the net operating loss carryback and carryforward treatment of the Federal National Mortgage Association to that of other financial institutions. The hearing will be held on Wednesday, December 9, 1981, beginning at 10:00 a.m., in room 1100 Longworth House Office Building, the main committee hearing room.

A representative of the Department of the Treasury will be the lead-off witness to be followed by Members of Congress and witnesses from the general public who have requested to be heard.

BACKGROUND INFORMATION ON H.R. 4717 AND H.R. 5011

The Crude Oil Windfall Profit Tax Act of 1980 (Public Law 96-223) included two provisions relating to LIFO inventory profits. Section 403(a) provided that LIFO inventory profits will not be recognized in certain narrowly defined circumstances if the taxpayer purchases replacement inventory within a defined period.

Section 403(b) of the Act provided that a corporation which distributes its LIFO inventory in a partial or complete liquidation or sells its inventory in the course of a 12-month liquidation must recognize the inventory's recapture amount as ordinary income unless the adjusted basis of the LIFO inventory is carried over to the acquiring corporation; that is, in these cases, any gain attributable to the excess of the adjusted basis of the inventory under the FIFO method over its LIFO basis would be subject to tax as ordinary income.

This provision is to be effective with respect to dispositions made pursuant to plans of liquidation adopted after December 31, 1981. The conference agreement included the delayed effective date in order to allow time for congressional hearings and to permit transactions in the planning stage to be completed.

H.R. 4717 (Mr. Jenkins) and H.R. 5011 (Mr. Gradison) amend section 403(b)(3) of Public Law 96-223 to defer the effective date of this LIFO recapture provision for one year, until December 31, 1982.

BACKGROUND INFORMATION ON H.R. 5013

H.R. 5013 would extend to the Federal National Mortgage Associaton (FNMA) the special rules for the carryback and carryforward of net operating losses that apply under Code section 172(b)(1)(F) to depository institutions, such as commercial banks and savings and loan associations. The Federal National Mortgage Association is a Government-sponsored private corporation. Its purpose is to provide supplementary assistance to the secondary market for home mortgages by supplying a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing.

Under H.R. 5013, the Federal National Mortgage Association could, with respect to any net operating loss for a taxable year beginning after December 31, 1981, carry back such net operating losses ten years and carry forward such losses five years.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony at the hearing should submit their requests to be heard by telephone to Harriet Lawler (202) 225-3627. The telephone request must be received by the Committee no later than the close of business, Wednesday, December 2, 1981. Following the initial telephone call, a formal written request should be made to John J. Salmon, Chief Counsel, Committee on Ways and Means, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

Requests to be heard must contain the following information:

(1) The name, address, title, firm affiliation and/or organization the witness will represent (as well as a telephone number where he or his designated representative may be reached);

(2) If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears; and

(3) A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the written record of the hearing.

PROCEDURE TO BE FOLLOWED FOR SUBMITTING TESTIMONY

In order to assure the most productive use of the limited amount of time available, witnesses scheduled to appear before the Committee are required to submit 125 copies of their prepared statement to the full committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the hearing. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

For those who wish to file a written statement for the printed record of the hearing in lieu of a personal appearance, five copies are required and must be submitted to the Committee office by the close of business, Wednesday, December 9, 1981. An additional supply of statements may be furnished for distribution to the press and public if supplied to the Committee office before the hearing begins.

Chairman ROSTENKOWSKI. Our hearing this morning deals with two issues. The first concerns a provision of the Crude Oil Windfall Profit Tax Act of 1980 that requires a liquidating corporation to recognize LIFO inventory reserves as ordinary income. The 1980 act applies to liquidation plans adopted after December 31, 1981. The two identical bills before us would extend that effective date by year to December 1, 1982.

The second issue before us concerns Fannie Mae, the Federal National Mortgage Association. The bill before us would change the rules for the carryback and carryforward of net operating losses of Fannie Mae. The 10-year carryback provision that now applies to depository institutions would be extended to Fannie Mae.

We welcome back to our committee our first witness, Assistant Secretary for Tax Policy, Mr. Chapoton. Welcome, Mr. Chapoton.

Before I recognize you, I would like to recognize Mr. Gradison.

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. GRADISON. Thank you, Mr. Chairman, for this opportunity to explore the recapture delay issue in committee today. As you know, I have been working some time to simplify existing LIFO accounting procedures to encourage their use by small business. LIFO enables a business to pay less tax during inflationary periods when the cost of goods they sell are more expensive. Boosting its operating capital increases a business' chance of surviving these inflationary periods.

Prior to the Economic Recovery Act of 1981, the LIFO system, although recognized by the IRS, was only used by those companies that could afford the personnel necessary to unravel its procedural complexities. The Economic Recovery Tax Act included several simplifications designed to enable small business to use LIFO.

Many of the simplifications were part of the package I introduced in May as H.R. 3606. However, one provision, the repeal of the unwise and unstudied LIFO recapture proposal, was not included. I later introduced H.R. 5011 to delay recapture because a thorough discussion of this complex procedure in committee was impossible before the provision's scheduled enactment on December 31 of this year.

I oppose LIFO recapture and support a 1-year delay to study its merits for the following reasons. First and foremost is that its inclusion in the windfall profit tax bypassed this committee. Second, Mr. Chairman, recapture discriminates unnecessarily against the LIFO method of accounting at a time when Congress and the administration have committed themselves to simplifying the system to encourage its use by small business.

Third, Mr. Chairman, this committee has commissioned a broad Treasury study of the specific question of how business inventory should be taxed. That study is not yet complete, and I don't believe we can wisely legislate with no hearings in this body and before the Treasury's policy recommendations are known and studied.

A fourth point, Mr. Chairman, is that section 472 of the code, which allows the use of LIFO in tax calculations, statutorily presumes that this accounting method clearly and accurately reflects income. Indeed, through various Treasury revenue rulings such as Revenue Rule 74-31, the Service reasoned that the LIFO method does not create a deduction or a tax benefit that must be recaptured, but LIFO is rather a technique of sequencing the flow of costs through a taxpayer's inventory.

I see an inconsistency and contradiction in claiming that there should be recapture in light of those rulings such as the one I just cited.

Finally, Mr. Chairman, a 1-year delay would incur a minimal revenue loss. The accounting community has advised their corporate clients who are even remotely considering liquidation to enter into a liquidation plan for safety before the end of the year. Under such a plan, a corporation would have 12 months to dispose of its assets from the date the plan was enacted.

If no delay is imposed, these companies will liquidate in 1982 without incurring this extra corporate tax even though the recapture legislation is in effect. If enactment is delayed, the liquidation

plan can be terminated. The December 31, 1981, deadline will only affect those smaller businesses without the benefit of professional accounting and tax assistance.

In summary, Mr. Chairman, I believe the premature enactment of LIFO recapture would erode the authority of this committee. It would create unnecessary confusion in the business community. It would build a broad and inconsistent new precedent into the tax code, and to put it plainly, it is a sloppy way to legislate.

I hope the distinguished members of this committee will join with Mr. Jenkins and myself in supporting delay so that hearings can be held at the earliest possible moment.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Thank you, Mr. Chairman, for the opportunity to explore the recapture delay issue in committee today.

As you know, I have been working for sometime to simplify existing LIFO accounting procedures to encourage their use by small business. LIFO enables a business to pay less tax during inflationary periods when the cost of the goods they sell are more expensive. Boosting its operating capital increases a business's chance of surviving these inflation periods. Prior to the Economic Recovery Tax Act of 1981, the LIFO system, although recognized by the IRS, was only used by those companies that could afford the personnel necessary to unravel its procedural complexities. The Economic Recovery Tax Act included several simplifications designed to enable small business to use LIFO. Many of these simplifications were part of a package I introduced in May as H.R. 3606. However, one provision, the repeal of the unwise and unstudied LIFO recapture proposal, was not included. I later introduced H.R. 5011 to delay recapture because a thorough discussion of this complex proposal in committee was impossible before the provision's scheduled enactment December 31, 1981. I oppose LIFO recapture and support a one-year delay to study its merits for the following reasons:

(1) First and foremost is that its inclusion in the Windfall Profit Tax Act (WPT), bypassed this committee. This initiative was added to the WPT bill at the insistence of the Treasury Department on the Senate floor. The conferees took the unusual step of delaying its enactment two years so it could be scrutinized through the proper committee hearing process. No business input was solicited in its creation. No accounting expertise was sought. The members of this committee were not even consulted. Indeed, this fundamental change in tax policy, directly bearing on thousands of domestic businesses and directing their business conduct in unknown directions, was researched, written, and promoted entirely by the Treasury Department with no public input. This precedent is dangerous. I don't think it is asking too much to allow community input and congressional understanding before passing any new tax law.

(2) Recapture discriminates unnecessarily against the LIFO method of accounting at a time when Congress and the Administration have committed themselves to simplifying the system to encourage its use by small business. How many small businesses can be expected to convert to LIFO when they see that such a system accumulates a huge tax debt due in full upon liquidation? This tax debt makes a business far less attractive to potential purchasers. It lowers the price a LIFO businessman can expect for his on-going business. It potentially precludes him from attracting a merger partner to salvage a failing enterprise. It restricts business flexibility and dictates policy abrogating the legislative tax goal of neutrality.

(3) This committee has commissioned a broad Treasury study of this specific question of how business inventories should be taxed. That study is not due until December 31, 1981. Can we really wisely legislate with no hearings in this body and before Treasury's policy recommendations are known or studied?

(4) Section 472 of the code, which allows the use of LIFO in tax calculations, statutorily presumes that this accounting method clearly and accurately reflects income. Section 403(b) WPT, which we are examining here today, is directly contrary to that presumption it assumes that by using LIFO a taxpayer derives a tax benefit which must be recaptured through two levels of taxation, first at the corporate level and, secondly at the shareholder level. Through revenue rulings

such as Rev. Rul. 74-431, the service reasoned that the LIFO method does not create a deduction or a tax benefit that must be recaptured, but LIFO is rather a technique of sequencing the flow of costs through a taxpayer's inventory. Now the Treasury Department urges us to overturn the presumptive legitimacy of this accounting system to find a tax benefit. How can an accounting technique which clearly reflected income in 1974, confer a tax benefit in 1981. This is just one of many contradictions that must be satisfactorily explained before this legislation goes into effect.

(5) Finally, a one-year delay would incur a minimal revenue loss. The accounting community has advised their corporate clients who are even remotely considering liquidation to enter into a liquidation plan for safety before the end of the year. Under such a plan, a corporation would 12 months to dispose of its assets from the date the plan was enacted. If no delay is imposed, these companies will liquidate in 1982 without incurring this extra corporate tax even though the recapture legislation is in effect. If enactment is delayed, the liquidation plan can be terminated. The December 31, 1981 deadline will only effect those smaller businesses without the benefit of professional accounting assistance.

In summary, Mr. Chairman, I believe the premature enactment of LIFO recapture would erode the authority of this committee. It would cause unnecessary confusion in the business community. It would build a broad and inconsistent new precedent into the Tax Code and, to put it plainly, it is a sloppy way to legislate. I hope the distinguished members of this committee join with Mr. Jenkins and myself in supporting delay so that hearings can be held at the earliest possible moment.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Gradison.

Mr. Chapoton, you may proceed.

STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

As you and Mr. Gradison have pointed out, the first matter for today is LIFO recapture, H.R. 4717 and 5011. Both of these bills would delay for 1 year until January 1, 1983, the effective date of the LIFO recapture provisions. These provisions were enacted as a part of the Crude Oil Windfall Profit Tax Act of 1980. The effective date was delayed until plans adopted after the end of 1981 so that hearings could be held, and to date no hearings have been held.

Treasury welcomes hearings on the merits of these provisions so that all points of view can be heard. But given the present state of the law, we think a delay is not advisable for the reasons I will state, and therefore we are opposing these two bills.

To provide a delay at this time would only cause disruption if Congress should decide to reinstate the LIFO recapture provisions. We believe that the recapture provisions are consistent with the principles and concepts of our present tax system, are consistent with the LIFO rules that are presently in the code, notwithstanding the restudy of those rules that may take place over the next several years; and as long as the present rules are in the code, the LIFO recapture provision should not be postponed without a hearing on their merits.

Under the present Federal income tax systems, inventories may be accounted for either on the FIFO, first-in, first-out method, or on LIFO, last-in, first-out method. These are, of course, methods for determining the flow of goods. The FIFO and LIFO methods are both assumptions as to the flow of goods that are actually sold in the year, and affect the determination of taxable income from the sale of inventory.

As a general rule, under our tax system the amount of gain realized and recognized for tax purposes is not adjusted for the effects of inflation. The LIFO method is a limited exception to this rule. By permitting the most recent higher inventory costs to be matched with current revenues, the LIFO method creates a deferral of tax on inventory profits in times of inflation. The gain deferred by the use of the LIFO method is equal to the excess of the FIFO basis of the tax inventory over its LIFO basis. This is the so-called LIFO reserve that is carried on the books.

In the context of an ongoing business, the use of the LIFO method creates a timing difference as to the costs reflected in the taxpayer's cost of goods sold for a particular year. The gain deferred, the LIFO reserve, will be recognized or recaptured in the ordinary course of business if the amount of inventory sold during a year exceeds the higher cost inventory acquired during the year. That is, recapture will occur if the inventory declines.

The deferred gain is also recognized under present law if the taxpayer makes a non-liquidating distribution of inventory. Under section 311(b) of the code, if, for example, a dividend of LIFO inventory is made, then recapture of the deferred gain is effected to the distributing corporation.

There is no similar recapturing provision under current law, however, in the case of a liquidating distribution of inventory or in bulk sales of inventory in the course of a corporate liquidation. Thus, any gain deferred by the use of the LIFO method can be permanently excluded from income where a corporation makes a bulk sale of its assets in the process of a liquidation.

And of course, the LIFO recapture provisions enacted in 1980 would reverse this result and would require the deferred LIFO benefit to be recognized in those cases. In effect, the LIFO recapture provisions recognize that the benefit of LIFO should be deferral and should not be a permanent exclusion of income.

When a corporation makes a nonliquidating distribution of inventories, as I have stated, we see recapture. We see no logical reason for a distinction between that type of distribution and liquidating distribution. The legislative history of the 1954 code from whence this distinction between dividend distributions or nonliquidating distributions and liquidating distributions gives no logical explanation for the difference in treatment.

Moreover, the recapture provisions do not represent a radical departure from established tax principles and concepts. LIFO recapture is conceptually similar to depreciation recapture. Depreciation is an assumption as to the wear and tear and obsolescence of tangible property. LIFO is an assumption as to the flow of inventory costs. Both result in a tax benefit.

The theory behind depreciation recapture in corporate liquidations is that if the fair market value of the assets distributed exceeds their adjusted basis, too much depreciation has been taken. Similarly, the theory behind LIFO recapture is that if the actual cost of the actual inventory distributed is higher than its LIFO cost on the books, inventory profits have been deferred and therefore should be recaptured.

We have heard and are sympathetic, Mr. Chairman, to the argument that the recapture provisions will cause tax profits that are

the result of inflation to be taxed as well as those attributable to true economic gains, and this is certainly true in part; but it is also true that our system now does tax inflationary profits. LIFO is not an indexing system nor was LIFO introduced into the system to result in a permanent escape of tax.

The purpose of LIFO in the tax law is not to permanently eliminate inflation but to allow the use of the LIFO assumption to reduce the tax of an ongoing business. Moreover, I should point out that it is not necessarily true that all of the amount recaptured under the LIFO recapture provision is caused by inflation. Significant amounts of real gain as well as inflationary gain are deferred when a taxpayer elects LIFO, and those deferred profits, I think, under any analysis of the provisions should be recaptured.

We think, in summary, that the recapture of the LIFO benefit in corporate liquidation is consistent with the theory and operation of LIFO and is consistent with the other rules in our tax system. We do not mean to say that alternative means of taxing inventory gains during times of inflation should not be considered, and indeed we are, as Mr. Gradison mentioned, studying the other means of taxing inventory.

But pending a decision to change our entire system, we think that recapture is consistent with the present rules. As I say, we would welcome hearings on this issue so that all views could be heard, but we do not think it is necessary to defer this provision for that to take place.

Turning to H.R. 5013, Mr. Chairman, this deals with the Fannie Mae tax loss carryback provision. Under present law, banks and savings and loan institutions and certain other financial institutions have a 10-year carryback period for losses and a 5-year carryforward, where most other business firms and Fannie Mae have a 3-year carryback and a 15-year carryforward period.

H.R. 5013 would change Fannie Mae's carry over period to be consistent with that of certain financial institutions, a 10-year carryback and 5-year carryforward, effective for losses incurred after calendar year 1981.

The administration supports enactment of H.R. 5013. To give you a little background, Fannie Mae was organized in 1953 as a Federal agency. It provided a secondary market for residential mortgages through the use of funds borrowed exclusively from the Treasury. In 1954 it became a mixed ownership corporation, the Federal Government owning preferred stock and private shareholders owning the common stock.

In 1968 it was rechartered as a privately owned and managed corporation subject to limited Federal supervision. So now it is a unique organization. It is privately owned with a Federal charter for public purposes. It is the largest single source of residential mortgage credit in the United States.

As I mentioned earlier, a great number of financial institutions, commercial banks, mutual savings banks, saving and loans, cooperative banks, banks for cooperatives chartered by the Governor of the Farm Credit Administration, small business investment companies, and business development corporations all have a 10-year carryback and a 5-year carryforward periods, which would be granted Fannie Mae under this legislation.

The 10-year carryback provision was adopted as part of the Tax Reform Act of 1969, and the House report at that time described it as an extra margin of safety for financial institutions to protect against the possibility of unusually large bad debt losses.

While Fannie Mae is not a thrift institution, it does have similarities to thrift institutions. It has like a thrift incurred a great deal of short-term debt to hold an asset portfolio consisting primarily of home mortage instruments, and because of these similarities in the debt-asset structure, the administration does support H.R. 5013, does support the 10-year carryback for Fannie Mae for losses incurred after the current calendar year.

The revenue cost of this proposal varies according to the projections of interest rates next year. There would be approximately a $200 million revenue loss under our current interest rate assumptions, but if interest rates begin dropping more dramatically, as may well be the case, then the revenue loss would drop considerably to around $35 million.

Moreover, it seems likely that Fannie Mae will not have losses after 1982, and therefore these revenue losses would in effect be recouped in 1983 and future years.

Mr. Chairman, that concludes the summary of our statement.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: H.R. 4717 and H.R. 5011 to further defer the effective date of certain provisions providing for the taxation, in corporate liquidations, of inventory profits previously deferred by use of the LIFO Method; and H.R. 5013 to conform the net operating loss carryback and carryforward treatment of the Federal National Mortgage Association to that of certain financial institutions.

H.R. 4717 and H.R. 5011
Postponing the Effective Date
of the LIFO Recapture Provisions

Both H.R. 4717 and H.R. 5011 would delay for one year (until January 1, 1983) the effective date of the so-called "LIFO recapture" provisions (sections 336(b)(3) and 337(f)(2)) of the Internal Revenue Code. Since no hearings were held on the recapture provisions at the time of their enactment as part of the Crude Oil Windfall Profit Tax Act of 1980, their effective date was delayed to provide an opportunity for such hearings and to provide opportunity for taxpayers to carry out transactions already in process. Until today no hearings had been held.

We understand that those who now urge a further delay in the effective date of the recapture provisions in order to provide additional time for hearings favor repeal of the provisions. Treasury welcomes hearings on the merits of these provisions so that all points of view can be heard. However, Treasury believes the provisions should become effective on January 1, 1982 and therefore opposes H.R. 4717 and H.R. 5011. Further delay at this time will not provide

taxpayers additional time to plan transactions since most taxpayers potentially affected by these provisions already have planned on their going into effect on January, 1, 1982. To provide a delay at this late time would only cause disruption if Congress should decide to reinstate the LIFO recapture provisions. We believe, for the reasons I will discuss, that the LIFO recapture provisions are consistent with the principles and concepts of our present tax system and should not be postponed without a hearing on their merit.

In defining gross income, section 61 of the Internal Revenue Code includes "gains from dealings in property." Thus, gross income includes the net difference between the amount received on a sale and the cost of the property to the seller. Inventory accounting determines the cost of goods sold in a particular period, thereby attempting to insure that for such accounting period, the proper costs are matched with the revenue of the period. Under present Federal income tax law, inventories may be accounted for on either the First-In, First-Out ("FIFO") method or the Last-In, First-Out ("LIFO") method. The LIFO and FIFO methods are assumptions as to the flow of goods which determine whether nominal inventory gains are realized as they occur or are deferred. Under FIFO, the first goods purchased (or manufactured) are presumed to be the first goods sold. Under LIFO, the last goods purchased (or manufactured) are presumed to be the first goods sold.

As a general rule under our tax system, the amount of gain realized and recognized for tax purposes is not adjusted for the effects of inflation. The LIFO method is a limited exception to this rule. By permitting the most recent, higher inventory costs to be matched with current revenues, the LIFO method creates a deferral of tax on inventory profits in times of inflation. The gain deferred by use of the LIFO method is equal to the excess of the FIFO basis of a taxpayer's inventory over its LIFO basis (the so-called "LIFO reserve").

The operation of LIFO can be illustrated by the following example. Assume a taxpayer has two items in inventory; one purchased at the beginning of the year at $5 and one purchased at the end of the year at $10. During the year, the taxpayer sells one item for $15. If the lower cost item were deemed sold, the taxpayer would realize and recognize a gain of $10 for tax purposes. However, if the taxpayer elected LIFO, he would compute his profit as if he sold the higher cost item and would report a profit of $5.00. Thus, in the context of an ongoing business, the use of the LIFO method creates a timing difference as to the costs reflected in the taxpayer's cost of goods sold for a particular year.

The $5.00 difference in the gain reportable under the LIFO and FIFO methods is deferred. The gain so deferred will be recognized, or recaptured, in the ordinary course of business if the amount of inventory sold during a year exceeds the higher cost inventory acquired during the year. For instance, if in the above example, the taxpayer had sold both items of inventory, there would have been no deferral. The deferred gain would also be recognized if the taxpayer were to make a non-liquidating distribution of inventory. Section 311(b) of the Code provides that, for example, a dividend of LIFO inventory causes recapture of the deferred gain to the distributing corporation.

However, under current law, there is no similar recapture provision in the case of liquidating distributions of inventory or in bulk sales of inventory in the course of a liquidation. Thus, any gain deferred by use of the LIFO method can be permanently excluded from income where, for example, a subsidiary corporation distributes its inventory in a section 332 liquidation and the parent is entitled to a stepped up basis in the assets distributed, or where a corporation makes a bulk sale of its assets in the process of liquidation. The recapture provisions enacted in 1980 would require the deferred LIFO benefit to be recognized in those cases.

It is important to note that what is being recaptured is not the appreciation in the inventory on hand, but rather the gain deferred by the LIFO-created timing difference as to cost. The provisions do not require the recapture of the LIFO benefit where the adjusted basis of the LIFO inventory in the hands of the acquiring corporation is carried over from the liquidating corporation since, in such a case, the deferred profit would be taxed when the inventory is ultimately transferred by the acquiring corporation in a taxable sale or exchange.

In effect, the LIFO recapture provisions recognize that the benefit of LIFO should be deferral and not permanent exclusion of income. As indicated above, section 311(b) of the Code enacted in 1954 provides for the recapture of the LIFO benefit when a corporation makes a non-liquidating distribution of inventory. We see no logical reason why the same rule should not apply to liquidating distributions.

Further, the legislative history of the 1954 Code does not indicate any rationale for the difference in treatment other than oversight. The history of section 311(b) (providing for the recapture of the LIFO benefit in non-liquidating distributions) indicates that Congress did

not intend that LIFO create a permanent deferral of tax. Section 311(b) originated in the House version of the 1954 Code. The House report explains the provision as one of two exceptions to the general rule that a corporation will not recognize gain or loss on distributions of its property as follows:

> "Two exceptions are made to this general rule, however, in order to preclude the use of avoidance devices under existing law. The first of these concerns distributions of LIFO inventory. In such cases, the amount of tax temporarily deferred under the LIFO method of accounting will be paid by the corporation if the inventory is distributed in kind to shareholders." (Emphasis added.) (H. Rep. No. 83-1337, 83rd Cong., 2nd Sess., p. 37)

The recapture provisions do not represent a radical departure from established tax principles and concepts but rather are consistent with the treatment of other tax accounting differences in corporate liquidations, such as recapture of depreciation, bad debt deductions, and adjustments for the use of the cash method and completed contract methods of accounting. The purpose of sections 337 and 334(b)(2) is not to allow less tax in certain corporate liquidations, but to provide for similar tax results from essentially similar economic transactions, despite the fact that such transactions take a different form. Section 337 was enacted to provide for similar tax treatment regardless of whether the liquidating corporation's assets were sold before or after the liquidation. The LIFO recapture provisions do not violate this principle. Section 334(b)(2) was enacted to provide for substantially similar tax results in either a direct purchase of assets or an indirect purchase through a stock acquisition followed by a liquidation. The recapture provisions do not violate this principle. However, current law by not providing for recapture does violate this principle as to the LIFO reserve. As a natural consequence of the use of LIFO, the reserve or LIFO benefit would be recognized when a company's assets are purchased directly (unless 337 were to apply), but would not be recognized if the assets are acquired through a section 334(b)(2) stock purchase and corporate liquidation.

LIFO recapture is conceptually similar to depreciation recapture. Depreciation is an assumption as to the wear and tear and obsolescence of tangible property; LIFO is an assumption as to the flow of inventory costs. Both result in a tax benefit which may or may not reflect economic reality. While accelerated depreciation differs from the use of the

LIFO method in that depreciation is a deduction from gross income while the LIFO method defers recognition of inventory profits, the tax effect of both provisions is identical. The theory behind depreciation recapture in corporate liquidations is that if the fair market value of the assets distributed exceeds their adjusted basis, too much depreciation has been taken. Similarly, the theory behind LIFO recapture is that if the actual cost of the actual inventory distributed is higher than its LIFO cost on the books, inventory profits have been deferred.

We have heard arguments to the effect that the recapture provisions would impose an unreasonable tax burden on some taxpayers. It must be noted, however, that over the period that a taxpayer has used LIFO, it has received substantial direct tax benefits in actual tax dollars saved as well as the benefit of being able to reinvest this tax saving. After a period of time, the taxpayer's actual after-tax income will be greater having used LIFO, than if FIFO had been used. When the taxpayer goes out of business, the recapture of the LIFO benefit or LIFO reserve represents the reversal of only a portion of the tax benefit LIFO has produced.

We have also heard and are sympathetic to the argument that the recapture provisions tax profits caused by inflation as well as true economic gains. While this is true, it is not a fault limited to the LIFO recapture provisions. The fact is our system does tax inflationary profits. What opponents of these provisions are really saying is that our present tax system, which includes LIFO, does not properly tax inventory profits in an inflationary economy, and what they are really arguing for is an indexing system which would eliminate inflationary gains. However, LIFO is not an indexing system. Nor was LIFO introduced into the system to result in a permanent escape of tax. It was provided to allow the use of a tax accounting assumption which inherently provides for tax deferral. The purpose of LIFO in the tax law is not to permanently eliminate inflation but to allow the use of the LIFO assumption to reduce the tax of an ongoing business. The argument that LIFO attempts to eliminate inflation is contrary to the principle that a reduction of LIFO inventory results in a recognition of income and that recapture in fact occurs upon liquidating sales of non-corporate entities, such as a partnership or sole proprietorship. Moreover, it is not necessarily true that all of the amount recaptured is caused by inflation. Significant amounts of real gain as well as inflationary gain can be deferred when a taxpayer uses LIFO.

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In summary then, we believe that recapture of the LIFO benefit in corporate liquidations is consistent with the theory and operation of LIFO in our current tax system. This is not to say that alternative means of taxing inventory gains during times of inflation should not be considered. However, given our current system and given LIFO it is the proper result.

Accordingly, we believe that the effective date of the recapture provisions should not be further delayed. Again, however, we would welcome hearings on these provisions to provide an opportunity for different points of view to be heard.

H.R. 5013 -- FNMA Tax Loss Carrybacks

H.R. 5013 would extend to the Federal National Mortgage Association (FNMA) the special loss carryback rules that apply under section 172(b)(1)(F) to certain financial insitutions, such as commercial banks and savings and loan associations. Under existing law, these institutions have a ten year carryback and five year carryforward period, while FNMA and most other businesses have a three year carryback and fifteen year carryforward period. Under H.R. 5013, FNMA would have a ten year carryback and five year carryforward period.

The Administration supports enactment of H.R. 5013.

Background. FNMA was organized in 1938 as a federal agency; it provided a secondary market for residential mortgages through the use of funds borrowed exclusively from the U.S. Treasury. In 1954 FNMA became a "mixed-ownership" corporation, with the federal government owning the prefered stock and private shareholders owning the common equity. In 1968 FNMA was rechartered as a privately owned and managed corporation, subject to limited federal supervision (both Treasury and HUD have certain supervisory powers). The President appoints five of its fifteen directors.

FNMA is a unique organization; it is a privately owned corporation with a Federal charter and public purpose. FNMA is the largest single source of residential mortgage credit in the United States, holding a sizeable portfolio of low-yielding, long term, fixed-rate mortgages funded with a large amount of short term debt, and is the largest private issuer of debt securities in the United States as well as one of the country's most highly leveraged corporation. Thus, the economic difficulties of most mortgage lenders -- a result of the risk inherent in borrowing short term and lending long term -- also afflict FNMA (although unlike savings and loans, FNMA is not required to borrow short term to hold mortgages).

According to FNMA estimates, their operating losses for 1980 and 1981 are of such magnitude that there will not be sufficient remaining income against which 1982 losses can be carried back under the three year rule.

Current Law. Sections 172(b)(1)(A) and (B) permit net operating losses to be carried back three years and forward fifteen. Certain financial institutions (commercial banks, mutual savings banks, savings and loans, cooperative banks, banks for cooperatives (chartered by the Governor of the Farm Credit Administration), small business investment companies and business development corporations) are permitted to carry losses back ten years and forward five years, under sections 172(b)(1)(F) and (G). Other financial institutions, such as insurance companies, are subject to the general rules.

The ten year loss carryback period provision was enacted as section 431 of the Tax Reform Act of 1969. Prior to that legislation, certain financial institutions were permitted to deduct additions to bad debt reserves on terms more generous than those applicable to taxpayers generally, to protect against potential catastrophic losses (according to the legislative history in the 1969 Act). The 1969 Act reduced the permitted deduction for additions to reserves. At the same time, the ten year carryback period was provided as "an extra margin of safety to protect against the possibility of unusally large bad debt losses...". H. Rep. No. 91-413, 91st Cong., 1st Sess., p. 121 (1969). The bad debt losses comtemplated by Congress apparently were those from failure to collect amounts due (in an economy like the Depression), rather than losses resulting from rising interest rates. FNMA was not covered by any of these provisions.

While FNMA is not a thrift institution, it does have certain similarities to these institutions. Most notably, FNMA, like a thrift, has incurred a great deal of short term debt to hold an asset portfolio consisting primarily of home mortgage instruments. Because of this similarity in debt and asset structure, the Administration supports H.R. 5013.

At the same time, however, we note that there are significant differences as well between FNMA and thrift institutions, especially the fact that while thrift institutions generally are required by law and charter to take deposits and hold mortgages (i.e., required to borrow short and lend long), FNMA is not. It is required to provide a secondary market for home mortgage instruments, but its recent practices of borrowing short term to hold long-term mortgages is the result of the judgment of its management. In light of the fact that FNMA is not a thrift institution, we believe that it would not be appropriate to extend other tax provisions applicable to thrifts to FNMA, such as the 40 percent bad debt deduction under section 593. We understand that FNMA will not seek such treatment.

Revenue Effect. Enactment of this proposal, given FNMA's expected interest rate scenario, will generate a revenue loss of approximately $200 million. If interest rates fall by 1 to 2 percentage points, the proposal will generate a revenue loss of about $35 million. The maximum potential revenue effect of the proposal would involve carrying back losses of $1.0 billion (the amount of FNMA prior year income not already offset by 1980 and 1981 losses) which would generate approximately $0.5 billion of refunds. Should interest rates remain high and FNMA remains unprofitable, additional refunds to FNMA under this proposal would represent a permanent loss to the Treasury. If interest rates decline and FNMA turns profitable, the Treasury would receive taxes from FNMA in excess of what will be received under present law since net operating loss carryforwards will be eliminated or reduced by the proposal.

Chairman ROSTENKOWSKI. Thank you, Mr. Chapoton.

Mr. Conable will inquire.

Mr. CONABLE. Thank you for your statement, Mr. Chapoton. There is some disagreement, evidently, about the issue of deferral of recapture. Has this been Treasury's position all along or has Treasury not taken a position?

Mr. CHAPOTON. We really have not addressed the question until this hearing.

Mr. CONABLE. You realize, of course, that we didn't have hearings on this at the time it was adopted as part of the windfall profits tax measure.

Mr. CHAPOTON. That's correct. When we met with groups on this this fall, Mr. Conable, we supported and we told them we would support hearings and indeed we thought hearings should be held, and we still think hearings should be held.

Mr. CONABLE. There is a serious question of whether we can have comprehensive hearings under the current time constraints. That is one of the reasons why there has been some interest in deferral. Also, the interest in deferral reflects a concern that taxing the gain on inventory at the time of a liquidation of a corporation may have the effect of a tax on inflation.

Do you have any comment about that? It would not be a big issue if there had not been a high level of inflation in the immediate past.

Mr. CHAPOTON. It would be diminished considerably. There is no question that a large part of the gain deferred resulting from an election to go to LIFO may be inflationary gain and therefore a large part of the gain that would be recognized under recapture is due to inflation. A part of it is not. A part of it is due to real gain. The amount of real and inflationary gain in any particular case depends on the circumstances of that case.

But as I stated in our written statement, the fact is that we do now throughout our system have tax on gains that are not real gains that are indeed inflationary gains. We do think that the entire inventory system should be reviewed to see if that problem is correctable, but in the meantime, our system doesn't make a correction. We do not have an indexing system. The LIFO method provides for deferral. And where you have deferral, it seems recapture at some point is appropriate. Recapture does occur under

current law, that is, upon a distribution of inventory; or indeed, if you sell inventory beyond current purchases.

Mr. CONABLE. It does result in the taxation of these gains twice; does it not? That is, as ordinary income at the corporate level and as capital gain at the shareholder level on liquidation.

Mr. CHAPOTON. Yes. All the recapture provisions have that effect, yes, sir.

Mr. CONABLE. And this effect also would have an application primarily to small business, would it not, and not to big business? They don't go through these liquidations normally.

Mr. CHAPOTON. Well, it is of interest to small business. It would apply to small and large businesses. A lot of large businesses are acquired in cash transactions.

Mr. CONABLE. But Treasury would oppose even the deferral, even for a year.

Mr. CHAPOTON. We think it is just not a good way to do business, to defer for a year and then come back and hold hearings and generate the confusion that it would cause. We think the provisions are right. They have already been deferred for a period of time. The law should be left as it is and then be reviewed, and if we are going to change it, we should change it only one more time; that is, if we are going to wipe this provision out, it we are going to eradicate it, then do it permanently, but not generate the confusion that a deferral at this late point would cause.

Mr. CONABLE. I must acknowledge that we defer too much, but if Treasury feels this is a proper role, you may be in better shape in getting it deferred than having it treated as the committee is otherwise likely to treat it.

Mr. CHAPOTON. Well, we do feel it is a proper rule, but it is not a question—it is a question that deserves reexamination. But a deferral we think probably causes more confusion than not deferring and studying the issue.

Mr. CONABLE. Well, there are those who look at confusion as better than taxation.

Thank you very much.

Mr. JENKINS. Mr. Chairman?

Mr. Chairman, as the author of H.R. 4717, which is identified to Mr. Gradison's bill, I want to submit a statement for the record. I will not read it but I want to say this. I am pleased to note that the Treasury has indicated that they would welcome hearings on these provisions, because they realize that no hearings have been held.

It is my position that the case for postponement is simple and compelling. The recapture provisions would obviously materially alter the rules relating to the treatment of inventories in corporate liquidations.

These rules have been in the Code since 1954 and until 1980 did not contain or even hint at the rule that Treasury urges on us now. The IRS itself issued a ruling in 1974 that explicitly concluded that LIFO as an accounting method does not produce a tax benefit subject to recoupment upon inventory disposition in a corporate liquidation.

With deferred, we can get into the merits of the matter, which we have never done before in this committee, as all of us know. At least 20 members of this committee and maybe more have asked for

the opportunity to have those hearings to decide on the merits of the case. Treasury indicates that they think we ought to do so, and we cannot do so in the short period of time remaining. It appears to me that the only reasonable alternative is to have a 12-month delay to give this committee the opportunity to consider this issue on the merits. Then we can decide whether to repeal or to leave it in the law.

To do otherwise would permit this to come into being in January, and then it may very well be that 4 or 5 months later we then repeal. So I submit that there would be more confusion by not deferring than there would be to simply defer for 12 months. We owe it to ourselves as legislators, to the prerogatives of this committee and to the taxpaying public itself to step back from this new provision that was enacted without any hearings, without any consideration on the merits, to postpone the effective date for 12 months, to look into the matter at that time, and to resolve it one way or the other.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. ED JENKINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA

Mr. Chairman, as you are aware, on October 7, 1981, I introduced legislation calling for a one-year postponement of the effective date of the so-called LIFO recapture requirement under sections 336 and 337 of the Internal Revenue Code. The provision is scheduled to become effective on January 1, 1982. My collegue, Mr. Gradison, has introduced an identical bill. I wish to applaud and thank the Chairman for convening the Committee in order to address the question of a one-year postponement.

The case for postponement is simple and compelling. The recapture provision would materially alter the rules relating to the treatment of inventories in corporate liquidations. These rules have been in the Code since 1954, and until 1980 did not contain or even hint at the rule that Treasury urges upon us. The IRS itself issued a ruling in 1974 (Rev. Rul. 74-431) that explictly concluded that LIFO, as an accounting method, does not produce a tax benefit subject to recoupment upon inventory disposition in a corporate liquidation. In 1980, without hearings in either body of Congress, without explanation in any public forum, the Treasury sought and accomplished as a floor amendment in the U.S. Senate to the Windfall Profit Tax Act the precise opposite of its expressed view in 1974. Our conferees, evidently troubled by the lack of prior review of this change, succeeded in delaying the effective date of the proposal. They did so in order that an assessment of its implications could be made. That assessment of substantive implications and merits still has not occurred and it quite clearly is too late in the year to do so.

Mr. Chairman, I realize that it is not the purpose of this meeting to explore the intricacies of LIFO accounting and the merits or demerits of this recapture provision. However, I do wish to note that I as well as many other members of the Committee have heard from business and professional organizations large and small that the provision has serious business planning implications; that it is inconsistent with the LIFO simplifications so enthusiastically enacted by Congress just this year in the tax bill; that it reflects a conceptual view of LIFO (last in-first out) and FIFO (first in-first out) as accounting methods that is at a minimum highly debatable whether these views once fleshed out for us prove to be compelling to Congress remains to be seen. What is indisputable is that this Committee and Congress as a whole have had no opportunity to reflect on this matter and make a fully informed judgment. We owe it to ourselves as legislators, to the prerogatives of this Committee and to the taxpaying public to step back from this new law, postpone it for one year, and look into the matter with care and resolve it, yea or nay, during that one-year delay.

Mr. GIBBONS. Mr. Chapoton, I can understand your pleas for regular order. I made that plea a lot of times myself. But this whole proposition came about by a very irregular process. This

amendment that you are asking us now to defer was slapped on in the Senate with nobody on the floor, no warning, no nothing. We caught it in conference under very adverse circumstances and had to accept it as a part of an overall package in order to get any kind of action done.

We have had more hearing on it than it deserves already this morning. As I see it, it is nothing more than a tax on inflation. Is there any way other than some imagined increase in the value of inventory, all of which would be inflation, in my opinion—I cannot imagine any inventory really increasing in value unless it were inflation, except scotch whiskey; that is about the only thing that goes up with age, or whiskey, not just scotch. But it would seem to me that if there were no inflation, there would be no tax; and we have tried to get rid of the tax. You know, one of the reasons for not taxing the sale of homes after the age of 55 was because we were really just taxing inflation. We have cut down the capital gains tax in order to try to wipe as much inflation out of it as possible.

So I guess my question to you is this: How could inventory increase in value if it were not for inflation, other than whiskey which I would admit would increase in value?

Mr. CHAPOTON. Mr. Gibbons, a major part of most LIFO reserves probably will be due to inflation, but inventories indeed do increase in value, and the wealth of firms increases when that happens.

Mr. GIBBONS. What kinds of inventories?

Mr. CHAPOTON. Any type of inventory of goods. If it increases in value faster than the rate of inflation, that is real value. It would be unusual that it increased at exactly the rate of inflation because of changes in the economy, demand for goods.

Mr. GIBBONS. Well, you know, most of those are just inflationary changes. Most things deteriorate while they are in inventory. Metal things rust, and food products go down in value. They all have certain shelf lives. The only thing I can think of really is whiskey that goes up in value the longer you keep it.

Mr. CHAPOTON. If the value of inventory in fact increases faster than whatever your index is—let us say it is the Consumer Price Index—then the firm has enjoyed a real increase in wealth. That is not an inflationary gain. It will have more real income when it sells those goods than it would have had if that inventory increased at exactly the rate of inflation.

Many things, supply and demand throughout the economy, affect the value of goods other than inflation. And then there are obvious examples such as metals.

Mr. GIBBONS. Let us get practical. What goes up because you keep it longer? You have made a theoretical argument. Just tell me some practical things that improve with age. You are younger than I. I will tell you, human beings do not improve with age. Now we have eliminated them.

Mr. CHAPOTON. You can have dramatic examples such as precious metals, but what I think we ought to deal with is more the real world of inventories, day-in-and-day-out inventories in a manufacturing concern in a retail establishment—that indeed as the real incomes of our citizens improve, demand might increase for certain goods and the value of those goods will increase. If we had abso-

lutely no inflation, inventory values would fluctuate, in any event, and——

Mr. GIBBONS. You have made a good theoretical argument, but name one thing that increases in value as you go along, just anything, you know.

Mr. CHAPOTON. Well, precious metals can increase, the value of clothing can increase, the value of shoes can increase, the value of anything may increase and indeed do increase.

Mr. CONABLE. Would the gentleman yield?

If it did not increase in value, there would not be any point in having LIFO.

Mr. GIBBONS. All we are doing is taxing inflation. I would be willing to amend the bill and take precious metals out of this thing if that is all you are really worried about, or whiskey or whatever you want.

Mr. CHAPOTON. We could, if we indexed—LIFO is not an indexing system, but there could be an indexing of inventory so that the adjustment would be solely for inflation, but that is not what LIFO does. I would concede that under today's climate particularly for some taxpayers the major portion of the LIFO adjustment, the LIFO reserve, will be attributable to inflation.

Mr. GIBBONS. Thank you, sir.

Chairman ROSTENKOWSKI. Are there further questions of the witness?

Mr. Heftel will inquire.

Mr. HEFTEL. Thank you, Mr. Chairman.

Mr. Secretary, I do believe you have probably presented the best case for enacting Mr. Jenkins' bill to extend the delay for enactment of the LIFO recapture provisions for inventory liquidation when you tell us, for instance, that clothing and shoes provide examples of noninflationary increases in value, very fashion and style oriented, and it is very difficult for fashions of yesterday to increase in value tomorrow. Precious metals are an obvious exception, but that is another case totally.

Second, as far as confusion is concerned, what could be more confusing than to enact the provisions and say we will hold hearings to find out whether or not we made a mistake? Why not hold the hearings to determine in advance whether or not you are going to make a mistake if you do enact the provisions? So I think you have really presented our case.

Thank you.

Mr. CHAPOTON. Well, let me say the confusion, of course, occurs. We are late. We are in mid-December. The taxpayers have had to plan with this being in the law in January, and from all standpoints a review of it earlier this year would have been better.

We have examined the provision and for the reasons I have stated in the testimony we think it is correct; therefore, we think it should go into place and that if Congress is going to make a change, let us make it only one more time, and that is to wipe it out altogether. But plans have now been made assuming that it will become law. If we now say well, it will not become law for another year and we postpone the plans for a year, then the confusion will occur about this time next year.

Mr. HEFTEL. I want to point out that the taxpayers who you say have planned for this to go into effect are the same taxpayers who are anticipating that this mistake will be rectified by the extension. As Mr. Conable pointed out, these taxpayers are much more interested in the confusion you are talking about than what I think is an unfair tax that simply seeks to tax inflation and has no other merit. And unless we want to tax inflation, I do not believe that we should adhere to your suggestion but rather should enact this delay of 1 year, hold the hearings, assess the merits of this case, and certainly not act upon a piece of legislation that taxpayers, you say, are planning on using but do not want and, we think, perhaps should not have to bear.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you.

As strange as it may seem, I find myself in agreement with the Treasury for a change. Could you give me a real life example of how this might apply, the change of a deferral to, let us say, the Marathon takeover? Would it have any application there, for instance?

Mr. CHAPOTON. Mr. Downey, I cannot answer that specifically. I rather doubt that it would, but I cannot actually say. The question would be the extent of the acquired company's inventory, question one; and question two, whether the company had in fact elected LIFO and if it had, the result would be that a gain that had been deferred as a result of the election of LIFO will simply be taxed at the corporate level in connection with the acquisition.

Mr. DOWNEY. I have no questions, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Chapoton.

Mr. JENKINS. Mr. Chairman, could I ask one further question of the witness?

If a large company wants to take advantage of the situation now, the only thing it has to do is file a notice of liquidation before the December 31 date; is that not right?

Mr. CHAPOTON. That is right. They have to adopt a plan of liquidation.

Mr. JENKINS. So the only people who will get hurt are the small businesses that do not have a battery of attorneys who know that they ought to file a plan of liquidation. I mean, any large corporate entity that may want to take advantage would simply file a plan of liquidation; is that not correct?

Mr. CHAPOTON. Simply to adopt a plan of liquidation, and I think small businesses that are even remotely considering liquidation are doing the same thing now, because they are planning on a law that is on the books, which they must do. If we postpone this, I suspect that they will be making these exact plans, and the same confusion will be in existence this time next year.

Mr. JENKINS. Unfortunately, I think there are hundreds of little businesses out in the countryside that have a one-lawyer, part-time representation and have no earthly idea of this provision. The people who will really be hurt are the small business people. The large corporate enterprise will simply file a plan of liquidation and be protected.

Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

Mr. DOWNEY. Mr. Chairman, I had one more question.

Chairman ROSTENKOWSKI. One more question, Mr. Chapoton.

Mr. DOWNEY. Mr. Chapoton, on H.R. 5013, I want to know whether or not the Fannie Mae sales, if they are concluded, would be considered ordinary or capital losses in your mind?

Mr. CHAPOTON. The losses involved would be considered ordinary losses.

Mr. DOWNEY. Can you give us—when they sell mortgages out of their portfolio, that is considered an ordinary loan?

Mr. CHAPOTON. Yes.

Mr. DOWNEY. Can you give me a revenue estimate, ordinary versus capital, what that would be?

Mr. CHAPOTON. I am sorry.

Mr. DOWNEY. Do you have any revenue estimates on what it is if it is an ordinary and what it is if it is a capital loss?

Mr. CHAPOTON. As I understand it, Fannie Mae's losses are really losses from operation; that is, their interest income is exceeded by their interest expense. Their dispositions would also enter into the formula; but for the most part, as I understand it, it is the cost of capital involved.

Mr. DOWNEY. The point that I think needs to be made is that what if they decide to start purging their portfolios of, you know, their low-yield mortgages? What do we do then? Conceivably there could be a fairly large revenue loss, could there not, if it is looked at in terms of ordinary loss?

Mr. CHAPOTON. You mean they could purge their portfolio to accelerate their losses, and so forth?

Mr. DOWNEY. Sure.

Mr. CHAPOTON. Well, I guess that is theoretically possible. Of course, they are an ongoing entity. I would not think that would——

Mr. CONABLE. Would the gentleman yield?

That has not been their practice, has it?

Mr. CHAPOTON. It has not been their practice.

Mr. DOWNEY. I understand it has not been their practice. Is it possible that they could absolve themselves of some of their tax liability if they started to do that?

Mr. CHAPOTON. I guess the thought would be an idea that they could increase in 1982, increase their loss by taking such action. I think they are constrained by many other factors from doing that. I suppose theoretically it is possible. They are, of course, subject to a great deal of public supervision, but I think you would have to talk to Fannie Mae directly about that.

Mr. DOWNEY. Then it is safe to say that you then agree with the joint committee estimate of a $14 million revenue loss?

Mr. CHAPOTON. What amount did you say?

Mr. DOWNEY. Fourteen million revenue loss, the joint committee estimate.

Mr. CHAPOTON. No. Our revenue loss is a bit higher than that, $35 million.

Mr. DOWNEY. But not $500 or $600 million. You do not anticipate that they will be purging——

Mr. CHAPOTON. That is correct.

Mr. DOWNEY. Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Chapoton.

We welcome to the committee our colleague, Mr. Nowak. It is always a pleasure to have you testify before the committee. You may proceed.

STATEMENT OF HON. HENRY J. NOWAK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. NOWAK. Thank you, Mr. Chairman.

It is a pleasure to come before this committee to discuss H.R. 4717, Mr. Jenkins' bill, and H.R. 5011, Mr. Gradison's bill.

These bills provide for further delay in the effective date of section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980, the so-called LIFO recapture provision, until December 31, 1982.

Section 403(b) generally provides that when a corporation distributes its LIFO inventory pursuant to a plan of liquidation adopted after December 31, 1981, it must recognize the inventory LIFO recapture amount as ordinary income.

The LIFO recapture provision should not be permitted to become effective on December 31, 1981, I believe for two reasons. First, section 403(b) was attached as an amendment to the Crude Oil Windfall Profit Tax Act without any discussion before a congressional hearing as to its merits.

I consider the procedure in which 403(b) became law as bad legislative policy and thus should be rectified by further delaying its effective date. Moreover, the conference report on the Crude Oil Windfall Profit Tax Act fully acknowledges that there were never any congressional hearings on that provision.

My second reason for seeking the delay of the effective date is probably even more fundamental. To the extent section 403(b) is permitted to become an operative provision on December 31, 1981, the argument can be made that the legislative commitment to LIFO simplification is being stifled. Section 403(b) could serve as a reason for many small businesses not to elect the beneficial LIFO method.

Currently, small business does not use LIFO. Based on 1976 IRS statistics on corporations, only 2.5 percent of all wholesalers and 1.3 percent of all retailers use LIFO. In response to these dismal statistics and as chairman of the Small Business Subcommittee on Tax, Access to Equity Capital, and Business Opportunities, I have become a strong advocate of comprehensive relief from the complexities inherent in the tax treatment of inventories. Last Congress my subcommittee conducted extensive hearings on the subject, and as a result released a report on inventory accounting as a burden on the capital formation process.

In providing the rationale for reform, the report states:

> Tax simplification of the inventory accounting methods, like depreciation reform, aids capital formation by increasing the internal cash flow of a business.
>
> There is, however, a fundamental difference in these two types of reform. Accelerated depreciation reform focuses on the needs of the capital intensive small business. On the other hand, inventory accounting reform aids the vast majority of small businesses, which are primarily labor intensive.

Tax simplification of accounting for inventories is vitally needed for the economy as a whole as well. For example, in 1978 there was 3.5 times as much corporate investment in total dollars in struc-

tures and equipment as compared to inventories. In that same year businesses understated their depreciation allowance on capital investment by $12.6 billion while inventory costs were understated by $24.2 billion. In other words, these statistics indicate that while there was a much greater amount of investment in structures and equipment in comparison to inventories in 1978, inventories were a more pronounced factor in the overstatement of business income for that year.

As a result of the Economic Recovery Tax Act of 1981, capital intensive business have been provided comprehensive accelerated depreciation relief. With respect to inventory tax reform, however, it only provides a small measure of reform. The road toward comprehensive inventory reform is just beginning. In this regard, I support the Ways and Means Committee in its efforts to accomplish this task.

Mr. Chairman, I received a request from Mr. Ireland supporting this request also, and I would ask permission that following my statement his support and letter to you be inserted in the record.

Chairman ROSTENKOWSKI. Without objection, it is so ordered.

[The letter referred to follows:]

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C., December 7, 1981.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Washington, D.C.

DEAR MR. CHAIRMAN: I appreciate the opportunity to advise your Committee by letter that I fully support the efforts of Representative Henry Nowak and others to delay the effective date of Section 403(b) of the Windfall Profits Tax Act to December 31, 1982.

When this section was enacted almost two years ago, there were no hearings held on this issue. This section was attached to the Windfall Profits Act as an amendment in the Senate. The only subsequent discussions of the issue were in the Conference Committee.

The Department of the Treasury is now doing a study on inventories. LIFO Recapture is an appropriate issue for that study. Therefore I believe a delay of Section 403 (b) is more than reasonable.

Sincerely,

ANDY IRELAND,
Chairman, Subcommittee on Export Opportunities
and Special Small Business Problems.

Chairman ROSTENKOWSKI. Are there any questions of Mr. Nowak?

[No response.]

Chairman ROSTENKOWSKI. Thank you very much.

Mr. NOWAK. Thank you, Mr. Chairman.

Mr. GIBBONS. Mr. Nowak, we appreciate your coming. You made a fine statement. I think we are going to act favorably on your legislation.

Mr. NOWAK. If I just may add, I think that the arguments that have been put forward by the previous witnesses as far as the confusion if this is acted upon now, it would seem from hearing from many different sectors of the small business community, that if is not delayed there will be even more confusion in the small business community. Those decisions will be delayed interminably because no one will know exactly what direction this committee

would take and you would be postponing an awful lot of business decisions until hearings are held and new legislation is enacted.

At least now they will have a year to know what the exact situation in the law is. So I would urge the committee to act, and I thank you very much for your consideration.

Chairman ROSTENKOWSKI. The next witness will be Mr. David Maxwell. When the committee returns at 11:20, we will take your testimony.

The committee will stand in recess until 11:20.

[Recess.]

Mr. GIBBONS. The committee will resume.

Mr. Maxwell, you may proceed.

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. MAXWELL. Thank you. I am David Maxwell. Since May of this year I have been Chairman of the Board and Chief Executive Officer of the Federal National Mortgage Association, which is generally known as Fannie Mae. I am pleased to have the opportunity today to testify in support of H.R. 5013, introduced by the chairman and by Representative Barber Conable, the ranking minority member. This bill would accord the Federal National Mortgage Association the same income and loss averaging treatment for tax purposes currently accorded other financial institutions.

I have submitted a statement to the committee, and with your permission, Mr. Chairman, I will just summarize it.

Mr. GIBBONS. We will insert it in full in the record.

Mr. MAXWELL. I would like preliminarily to address the question Mr. Downey asked Secretary Chapoton concerning the possible sale of mortgage loans by Fannie Mae. It is my understanding that in the past there were only very small amounts of such sales. The losses incurred, if any, or gains from these sales were treated as ordinary income and not as capital gains.

Fannie Mae has no intention of selling a volume of mortgage loans out of its portfolio. Our business plan includes no such arrangement. There are sound business reasons, including the incurring of additional losses, why we would not want to do that. Any losses that we did incur by selling such loans, to the extent that they affected our taxes, could of course be carried forward in the future and used to offset taxes that we would otherwise pay when we return to profitability.

Fannie Mae's history and role as a financial institution were covered by Secretary Chapoton in his statement. I would like to emphasize to the committee that the only purpose for which Fannie Mae exists is to provide liquidity to the home mortgage market. That is the statement of our purpose in our congressional charter and that is the only business in which we have ever engaged.

Our modus operandi pursuant to that purpose has been to borrow money in capital markets to use to purchase mortgages from primary lenders. These purchases provide the primary lenders with more money to make additional home mortgage loans. We have served the moderate-income housing market. Our single

family mortgage purchase ceiling is $98,500. We have also worked with Ginnie Mae in many programs for low-income homeowners.

As a result of Fannie Mae's operations since it was rechartered in 1968 and became a private corporation in 1970, the corporation has accumulated a portfolio of $60 billion of home mortgage loans. That is one in every 20 home mortgage loans outstanding in the United States. In the course of acquiring those loans, Fannie Mae has accumulated a debt of roughly $58 billion. We are constantly borrowing in the capital market to refund that debt, which is shorter term than the mortgages that we have purchased.

Fannie Mae has made a significant contribution to housing in accordance with its congressional charter and its purpose. In past periods of tight housing credit, Fannie Mae has stepped in to buy large quantities of mortgage loans in order to keep the market going.

This year has proved no exception. Even though Fannie Mae has had such problems, with which the committee is familiar, we nevertheless have purchased about $5 billion in mortgage loans. This amounts to some 93,000 mortgage loans around the country. In fact, Fammie Mae has been known often this year as "the only game in town" in the secondary mortgage market.

So we have served and continue to serve as a bank chartered by Congress to invest in mortgages. H.R. 5013, the Rostenkowski-Conable bill, would accord Fannie Mae the same tax treatment other financial institutions receive with regard to losses generated by such long-term investment in mortgage loans.

At the moment Fannie Mae's tax carryback and carryforward arrangements are like those of a manufacturing company or a commercial enterprise: We may carry losses 3 years back and 15 forward. H.R. 5013 would give Fannie Mae a 10-year carryback and 5-year carry forward like other financial institutions.

The thrift institutions and banks were given a carryback of 10 years and carryforward of 5 years by the Congress in 1969, when Fannie Mae was still regarded as a public rather than a private corporation. Although the grant of a longer carryback in 1969 was linked to a reduction in the bad debt reserves of the thrifts and the banks, the same longer carryback was also accorded to the banks for cooperatives, which had no special bad debt treatment. Banks for cooperatives are in fact specialized banks to help provide farm credit, as Fannie Mae is a specialized bank to invest in mortgages.

Fannie Mae's and thrift institutions' profits and losses are affected by the same economic conditions in the same way. That fact is well borne out by our collective current situation. At the moment our $60 billion of mortgages are yielding an average return of 9.7 percent while we have paid as much as 18 percent to turn over our debt during the course of 1981. Consequently we, like the thrifts, have a negative spread on our portfolio between the yield of the mortgages and the cost of the debt.

The effective date for this amendment would be for losses beginning in 1982, so the carryback would extend to 1972. H.R. 5013 would It will provide us with a needed tool for budgetary and management planning in 1982.

I want to emphasize for the committee that, while the actual estimates of revenue effect in 1983 depend to a certain extent on

interest rate levels during the year 1982, the net effect of this bill will be that it will not cost the taxpayers a penny over the long run. This is because whatever the budgetary impact in early years, the revenues will be returned to the Treasury when Fannie Mae pays taxes in the future on taxable income which would otherwise have been offset by the 15-year loss carryforward available under current law.

For these reasons, I urge the committee to act favorably on H.R. 5013. I would be glad to answer any questions the committee has.

[The prepared statement follows:]

STATEMENT OF DAVID O. MAXWELL, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, FEDERAL NATIONAL MORTGAGE ASSOCIATION

Mr. Chairman and Members of the Committee, I am David Maxwell. Since May of this year I have been Chairman of the Board and Chief Executive Officer of the Federal national Mortgage Association, usually called Fannie Mae. I am pleased to be here today to testify in support of H.R. 5013, introduced by Chairman Dan Rostenkowski and Represrntative Barber Conable, the ranking minority member. This bill would accord the Federal National Mortgage Association the same income and loss averaging treatment for tax purposes currently accorded other financial institutions.

The Federal National Mortgage Association began in 1938 as part of the federal government. After several reorganizations, in 1968 the Congress enacted legislation to charter Fannie Mae as a private corporation, with a statutory mandate to provide assistance, liquidity, and stability to the home mortgage market. In accordance with that legislation, Fannie Mae became provate in 1970. Fannie Mae has a fifteen person Board of Directors, ten elected by the holders of its 59,000,000 shares of stock and five appointed by the President of the United States. It is subject to a certain degree of regulation by the Secretary of Housing and Urban Development and the Secretary of the Treasury.

Today FAnnie Mae holds $60 billion in mortgages—one of every 20 home mortgages in America. It purchases these mortgages from originators, such as mortgage bankers, savings and loan associatons, and commercial and savings banks, to provide them money to lend more people to buy homes.

Fannie Mae has obtained the money to purchase these mortgages largely through short of medium term borrowing in the credit markets. Fannie Mae's debt—about $58 billion—is held by banks, savings and loan associations, state governments, foreign central banks and other investors. Fannie Mae's obligations constitute a significant portion of the portfolios of many of these institutions.

Fannie Mae is a financial intermediary, spanning the gap between the real estate and finance markets. It improves the efficiency of the housing finance market, thus permitting housing to compete for investment dollars. Fannie Mae's operations transform mortgages from small, illiquid, and local investments into blue-chip corporate paper which attracts needed money to housing. Given Fannie Mae's national scope, it also channels mortgage funds from regions of greatest availability to regions of greatest need. And Fannie Mae has worked with Ginnie Mae—the Government National Mortgage Association—to use the market mechanism to increase the availability of low and moderate income housing. (GNMA was established in 1968 as part of the Department of Housing and Urban Development to carry out government-subsidized mortgage programs and help provide financing for FHA and VA mortgages.)

Fannie Mae is a key to maintaining a stable flow of money into the mortgage sector. During past periods of credit shortages and high interest rates, Fannie Mae has responded with extensive mortgage purchases to help prevent even more severe disruptions in housing. This year has been no exception. Indeed, there have been several periods this year when Fannie Mae has been described as "the only game in town" in the secondary market. So far in 1981, Fannie Mae has purchased some 93,000 home mortgage loans with a total value of about $5 billion.

For years, Fannie Mae was able to borrow short term at interest rates that were traditionally lower than the long term mortgage rates. Since 1978, this relationship between short and long term rates has changed: generally short term interest rates have been higher than long term interest rates. In addition, the general upward movement of all interest rates has left Fannie Mae locked into a portfolio of long term assets that yields less than it must pay to turn over its debt. As a result,

Fannie Mae's $60 billion in mortgages yield today an average rate of return of 9.7 percent. But we have borrowed money at rates up to 18 percent in 1981 to finance this portfolio and to continue to carry out our Congressional mandate to provide funds for housing.

H.R. 5013 would accord Fannie Mae the same tax treatment other financial institutions receive with regard to the losses generated by long term investment in mortgage loans. The present tax code permits businesses generally, such as retailing and manufacturing companies, to average income by permitting them to carry net operating losses back for three years and forward for fifteen years. Fannie Mae is treated like such a company. On the other hand, other finaicial institutions, such as commercial and savings banks and savings and loan associations, are allowed a ten year carryback and a five year carrvforward. As a matter of tax equity and parity, Fannie Mae should be treated like these financial institutions, rather than like retailers and manufacturers.

The special loss carryback provision for financial institutions was enacted by the Congress in 1969, at a time when businesses generally were permitted to carry losses back only three years and forward only five. The Congress gave this special treatment to financial institutions for a number of reasons.

In 1969, the Congress was beginning to trim back special bad debt deductions for financial institutions. At the same time, it recognized the desirability of protecting such institutions from substantial losses brought about by future downturns in the economy. The Joint Committe on Taxation's General Explanation of the Tax Reform Act of 1969 states that a reason for the ten year carryback was to provide such protection.[1]

Fannie Mae has never had any exceptional bad debt treatment to help it during extended cyclical downturns. Moreover, its Congressional charter restricts it to a business that is particularly susceptible to large market swings. The Senate Report on the Tax Reform Act of 1969 specifically noted "the peculiar risks of long-term lending on residential real estate," and added that such lending was "an activity which Congress has indicated it desires to encourage."[2] Long term home mortgage loans have been the mainstay of the business of both the thrift institutions and Fannie Mae.

It is important to note that the 1969 amendments did not limit the ten year carryback treatment to institutions relinquishing a part of their special bad debt treatment. The amendments also applied the carryback to banks for cooperatives. Like Fannie Mae, banks for cooperatives had no special bad debt treatment.

Fannie Mae is comparable to the financial institutions given the ten year carryback in 1969. If is essentially a bank chartered by the Congress to invest in mortgages. Like the thrift institutions, Fannie Mae's business is to raise money which it uses to acquire residential mortgages, albeit at the secondary level. The same economic conditions affect the profits and losses of Fannie Mae and the thrift institutions in the same way. Our common experience has made it apparent that Fannie Mae has business and financial cycles which are tied tightly to those of the thrifts and other financial institutions, and both logic and equity argue that Fannie Mae should have the same carryback and carryforward treatment.

However, it is easy to see how Fannie Mae was apparently overlooked when the 1969 tax amendments were adopted. Although the Congress pased the law to charter Fannie Mae as a private institution in 1968, Fannie Mae was widely regarded as a part of the federal government during 1969. The law scheduled Fannie Mae's transition to private status for sometime between 1970 and 1973.

I strongly support the amendment, and urge that the Congress expeditiously enact H.R. 5013, and grant Fannie Mae the same income averaging treatment enjoyed by other financial institutions.

The effective date for the proposed amendment would be for losses for years beginning with 1982. The carryback would be to years commencing in 1972.

Although this amendment will provide Fannie Mae with a needed planning and management tool in 1982, it will have no budgetary impact until fiscal 1983. Its budgetary impact in future years depends on interest rate conditions. If interest rates continue to decline, as they have recently, the budgetary impact could be $40 million or less in fiscal 1983. If interest rates stabilize or begin to climb again early next year, the short term budgetary impact could be higher.

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[1] Staff of the Joint Committee on Taxation, 91st Cong., 2nd Sess., General Explanation of the Tax Reform Act of 1969 at 147 (Comm. Print 1970) (discussing section 431 of the Act and section 172(b)(1)(F) of the IRC).

[2] 1969-3 C.B. 526, from S. Rep. No. 91-552, 91st Congress, 1st Sess., 162 (1969).

When a longer time frame is taken into consideration, however, the amendment produces no real revenue loss. Whatever the budgetary impact in early years, the revenues will be returned to the Treasury when Fannie Mae pays taxes in the future on taxable income which would otherwise have been offset by the fifteen year loss carryforward available under current law. H.R. 5013 simply permits Fannie Mae to carry its losses back now instead of forward in the future. Thus, the amendment's long range revenue impact is primarily to shift the revenue loss to a more propitious time for the nation's housing and lending institutions.

In closing, let me reiterate my appreciation for this opportunity to testify.

Mr. GIBBONS. Mr. Conable?

Mr. CONABLE. May I ask you what you are paying for money now, Mr. Maxwell?

Mr. MAXWELL. Yes, sir. At the moment, we just issued a 4-year, 8-month debenture in the amount of $1.3 billion, and we paid 13.9 percent for that money.

Mr. CONABLE. That's a substantial improvement, is it?

Mr. MAXWELL. Yes, sir.

Mr. CONABLE. Are you able to realine your debt at this point to take advantage of some of the improved interest rates?

Mr. MAXWELL. Yes, sir. That was the reason for our borrowing at 4 years and 8 months. The average life of our debt is 2 years and 7 months. We are currently endeavoring to lengthen the life of our debt, to give us more stability.

Mr. CONABLE. Thank you.

Your position is, you consider it very analogous to the thrifts, do you not?

Mr. MAXWELL. Yes, sir.

Mr. CONABLE. In view of your mandate, that's not surprising.

Well, thank you very much. I am not aware of any substantial opposition to this provision. I am persuaded, actually, that it may simply have been a legislative omission that you were not included in the earlier carryback legislation.

Mr. MAXWELL. Thank you, Mr. Conable.

Mr. GIBBONS. Further questions?

[No response.]

Mr. GIBBONS. Thank you, Mr. Maxwell.

Our next group of witnesses is a panel composed of Mr. John V. Jones and Mr. William Sutherland. Mr. Jones is representing the American Bar Association and Mr. Sutherland is representing the American Institute of Certified Public Accountants. Mr. Jones will be accompanied by Mr. James P. Holdon.

Yes, sir, Mr. Jones, you may proceed right away and your full statements are in the record without objection at this point. And take off.

STATEMENTS OF JOHN B. JONES, JR., VICE CHAIRMAN OF GOVERNMENT RELATIONS OF THE SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, AND JAMES P. HOLDEN, CHAIRMAN, LIFO RECAPTURE TASK FORCE

Mr. JONES. Thank you, Mr. Chairman. I want to make it clear that I am representing the section of taxation of the American Bar Association and not the bar association itself.

I have James Holden with me here. He is our council director and is chairman of the LIFO Recapture Task Force, and he will present the highlights of our written statement.

Just let me say that we regard this as a very tough problem. It is not as clear to tax lawyers as it is to the Treasury that all tax benefits must be recaptured. Some tax benefits are there to properly record taxable income and the need for recapture does not follow from that.

And if it is decided that there should be recapture, there are some very important procedural considerations as to what should be done when one moves to the recapture situation. These have never been considered by the committee and we think they should be now.

Like the Treasury, we wish there had been hearings. But we draw a different conclusion from the failure to have hearings. We think the need for consideration still exists and we urge this committee to approve the bills and I will pass it over to Mr. Holden.

Mr. HOLDEN. Mr. Chairman, the tax section does not appear before you to urge that this legislation or these amendments are correct or incorrect. We do urge that hearings should be held on them because first there are serious substantive questions about the tax policy reflected in the amendments; and second, if these amendments do become effective they do have serious substantive defects in themselves. That is, if the committee is to adopt the recapture mode, these particular amendments are defective and should be changed.

For that reason, it seems to us incorrect for Treasury to come before the committee and say that it supports hearings and yet the amendment should become effective. These defects are serious enough that they should be discussed in hearings before the amendments become effective.

With regard to the tax policy reflected in the amendments themselves, Treasury assumes the basic issue and that is that the use of LIFO results in deferral or a tax benefit to the taxpayer. That depends upon the manner in which the taxpayer conducts his business. Certainly in a grocery store if they are selling perishable merchandise, then it is obvious that the first goods in are going to be the first goods sold.

That conclusion is not so obvious if the taxpayer is selling goods, bulk goods out of a bin, where the latest addition to the bulk goods are thrown on top and then are sold out of the bin. In that circumstance it is quite probable that the last-acquired goods are the first sold, which is the LIFO assumption.

These inventory methods do only one thing for us, and that is they help us determine which goods have been sold. If the taxpayer has in fact been selling the last acquired goods first, then LIFO is not providing him with an untoward benefit that should be recaptured. This subject should be examined by the committee in hearings.

Second, with respect to the amendments themselves, Treasury defends these amendments by referring to what this Congress has done in the way of depreciation recapture. However, when in 1962 the Congress adopted depreciation recapture it at that time exempted from recapture all depreciation accumulated prior to 1962.

With regard to these amendments, LIFO taxpayers that have accumulated reserves have done so without notice of recapture,

and it seems that if that analogy is to be drawn, the existing LIFO reserves should be grandfathered and not subject to recapture. If that were done, then this "cliff effect" that is faced on December 31 would no longer be with us. That is, only the LIFO reserves accumulated after January 1 would in any event be recaptured.

So it's not sensible to proceed to let this legislation come into effect with those kinds of issues, and for these reasons the section of taxation, Mr. Chairman, does support deferral.

[The prepared statement follows:]

STATEMENT OF JOHN B. JONES, JR., AND JAMES P. HOLDEN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. Chairman, I am John B. Jones, Jr., Vice Chairman Government Relations of the Section of Taxation of the American Bar Association. I am accompanied by James P. Holden, a member of Council of the Section of Taxation and Chairman of our Task Force which has studied the LIFO recapture question.

Our comments reflect the position of the Section of Taxation of the American Bar Association on the above bills, which would defer the effective date of certain provivisions of the Internal Revenue Code that require liquidating corporations to recapture LIFO reserves. The views expressed should not be construed as representing the position of the American Bar Association, which has not considered this matter. For the reasons set forth below, the Section of Taxation supports the deferral of the effective date of these provisions.

1. INTRODUCTION—THE NATURE OF A LIFO RESERVE

In evaluating the desirability of this legislation it is helpful to review briefly the nature of the so-called "LIFO reserve."

A taxpayer who maintains an inventory of goods held for sale must constantly replenish that inventory as goods are sold. The cost of units purchased to replenish the inventory does not remain constant and replacement units are generally acquired at various prices. In an inflationary economy the cost of replacement units will normally increase over time, with the result that more recently purchased units will have a relatively higher cost than will units purchased at an earlier date. If the inventory units are not susceptible to ready physical identification, a taxpayer must adopt some system to determine, as sales occur, whether he is selling the higher cost units or the lower cost units. If he does not do this, he cannot compute his cost of goods sold and his taxable income.

Two common accounting systems for determining which inventory units have been sold are FIFO and LIFO. Under the FIFO (or "first-in-first-out") method, the first goods purchased are deemed the first sold, and income or loss from sales is computed accordingly. Under the LIFO (or "last-in-first-out") method, the last goods purchased are deemed the first sold, and income or loss from sales is computed accordingly.

In a period of inflation, a taxpayer using the LIFO method will generally have a relatively lower taxable income because his cost of goods sold will be determined by reference to the cost of the more recently purchased, and hence more expensive goods. Since LIFO taxpayer will be deemed to have sold the relatively higher cost units, he will also be deemed to retain the relatively lower cost units. Those lower cost units will generally have an actual cost below their replacement cost or their fair market value. This differential is known as the "LIFO reserve." If the inventory on hand were to be sold, the taxpayer would realize taxable ordinary gain to the extent of this amount.

The present question is whether a liquidating corporation should be treated as having sold its LIFO inventory, with the result that liquidation would trigger the inclusion in income of its LIFO reserve.

2. PRESENTLY EFFECTIVE LAW DOES NOT REQUIRE RECAPTURE

Under the Internal Revenue Code, when a liquidating corporation distributes inventory assets to its shareholders, the distribution does not constitute a taxable sale. Section 331 IRC. Similarly, if a liquidating corporation makes a bulk sale of its inventory assets within twelve months before its complete liquidation, no gain or loss is recognized on that sale. Section 337 IRC.

The Internal Revenue Service has held, under presently effective law, that these principles of nonrecognition apply to distributions and sales of LIFO inventory assets in the same fashion as they apply to other assets having a cost basis that is less than fair market value. Consequently, there is no requirement, under presently effective law, that the amount of the LIFO "reserve" be included in the income of a liquidating corporation.

3. RECAPTURE WOULD BE REQUIRED FOR PLANS OF LIQUIDATION ADOPTED AFTER DECEMBER 31, 1981

Section 401(b)(1) of the Windfall Profit Tax Act of 1980 amends current law effective January 1, 1982. This amendment requires a liquidating corporation to include in ordinary income the amount of the LIFO reserve, i.e., the amount by which the cost of the inventory assets as determined under the FIFO method exceeds their cost as determined under the LIFO method.

4. POSITION OF THE SECTION OF TAXATION

The Section of Taxation recommends that the effective date of these amendments be deferred for at least one year for the following reasons.

a. Lack of hearings

The amendments made by the 1980 legislation affect a wide variety of taxpayers. Despite this, the amendments were adopted without notice and without hearings. The Conference Report indicates that the effective date was deferred initially to January 1, 1982, in order "to allow time for Congressional hearings on this provision." H.R. Rep. No. 96-817, p. 161. The contemplated hearings should be held in order to give affected parties the opportunity to come before this Committee and to share with the Committee their views on the merits of the legislation.

b. Substantive merit not clear

A requirement that the LIFO reserve of a liquidating corporation be recaptured may or may not have merit. As discussed above, an inventory method merely determines which units are sold first. If the method accurately reflects the taxpayer's operations, there is no justification for recapture. For example, if a taxpayer using the LIFO method does in fact sell first the more recently purchased units, then he does in fact retain the older, lower cost units, and there is no justification for treating him as if he did not. There is clearly a significant difference in the inventory flow for a seller of perishable goods (whose inventory should move on a FIFO basis) and a seller of bulk, fungible goods from a storage location (whose inventory may well move on a LIFO basis).

There is a substantial difference of opinion among members of the Section of Taxation as to whether the 1980 amendments correctly resolve these problems. These issues were not explored prior to adoption of the amendments and they should be considered prior to their effectiveness.

c. Serious defects in the statute

Even if the amendments are permitted to become effective, they should be modified in substantial respects. The amendments would require recapture of the entire LIFO reserve, regardless of the period over which it has been accumulated. This is unfair to taxpayers who adopted LIFO without notice of any requirement for recapture. When faced in the past with similar situations, Congress has exempted the pre-enactment element from recapture. For example, when depreciation recapture was adopted in 1962, pre-1962 accumulations of depreciation were exempted. Similar action appears warranted here.

In addition, the amendments would recapture the entire spread between the LIFO and FIFO basis. This fails to account for the fact that an inventory that is sequenced on the FIFO method can be valued on a "lower of cost or market" basis. Recapture should be limited to the amount by which the lower of cost or market exceeds the LIFO basis. When Congress addressed this identical subject in Section 311(b), relating to the recapture of LIFO reserves on nonliquidating corporate distributions, it so defined the recapture amount. There is no apparent reason for a different definition here.

d. Lack of relevance to accompanying legislation

The Windfall Profit Tax Act of 1980 permitted LIFO taxpayers, in certain defined circumstances, to avoid the undesirable tax consequences that would otherwise flow from declines in the level of their LIFO inventories. It is probable that this provision was primarily of interest to larger, publicly held energy companies.

The LIFO recapture amendments appear to have been added as a consequence of the above liberalization and out of a desire to insure that LIFO accounting had not been made overly liberal. However, the recapture amendments will impact most heavily on the smaller, closely-held corporations that engage in complete liquidations more frequently than do larger publicly held corporations. Consequently, the recapture amendments do not appear responsive to the probable objective that Congress had in enacting them.

CONCLUSION

For these reasons, the Section of Taxation recommends that the effective date of the recapture amendments be deferred and that Treasury be directed to study the significant tax policy questions presented by them.

Mr. GIBBONS. Thank you.
Mr. Sutherland.

STATEMENT OF WILLIAM R. SUTHERLAND, MEMBER, TAX ACCOUNTING SUBCOMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. SUTHERLAND. Mr. Chairman, my name is Bill Sutherland. I am a partner in the CPA firm of Touche, Ross & Co. I am active in the Federal Tax Division of the American Institute of Certified Public Accountants, and I am here today representing the AICPA.

Mr. GIBBONS. Your entire statement is in the record.

Mr. SUTHERLAND. The purpose of my statement is to support deferral of the effective date of the LIFO recapture provisions so that hearings can be held to consider the merits of the provision. In this connection, with the Economic Recovery Tax Act requiring Treasury to conduct a full and complete study of inventory matters with a view toward simplification, we believe that these two matters should be considered together.

In order to support our position in favor of deferral of the effective date of the tax, it is necessary to identify a few problem areas that we see in the provision as it presently exists. No. 1, as a matter of tax policy why should Congress single out LIFO inventories for double taxation of unrealized appreciation due to inflation?

Section 336 of the Internal Revenue Code establishes the general rule that no gain or loss shall be recognized to a corporation on the distribution of property in liquidation. Sections 1245 and 1250 create exceptions for this general rule relating to depreciation recapture. These sections "recapture" a deduction, namely depreciation which is specifically allowed by statute.

There is no such deduction in the case of LIFO. LIFO is a measure of cost. If inventory could have more than one measure of cost, what is the rationale of a tax policy that says the difference between the two measures of cost constitutes taxable income?

LIFO recapture merely taxes unrealized appreciation in inventories. For example, take the case of a land developer that purchased some property 10 years ago and now is going to distribute that land to its shareholders in complete liquidation. There will be no taxation to the corporation in that situation.

But contrast that with your corner hardware store, that may have adopted LIFO 10 years ago and now will be distributing this inventory to its shareholders in liquidation. Why should one com-

pany pay tax on the difference whereas the other company does not?

Two, LIFO is an acceptable method of determining costs. It is not a loophole. It is not a special allowance. It is not a tax expenditure. LIFO is a method of determining cost of inventory on hand for balance sheet purposes, and the matching of the flow of such costs against revenues for income statement purposes.

In an inflationary economy this matching process should not be misinterpreted as merely a deferral of taxable income. In an inflationary economy, LIFO might reduce both financial and taxable income by removing inflation-related profits from such income.

The LIFO recapture provision does not affect other methods of inventory accounting, such as specific identification or average cost, which could reduce the tax basis of inventories below FIFO cost. I think that is an important point that has not been recognized much so far.

Three, I think this is important: The LIFO recapture provision can, and in some cases I know it will, based upon my past experience, tax nonexistent gain. In this regard, compare LIFO recapture with depreciation recapture. Depreciation recapture is the difference between the depreciated basis of section 1245 property and the fair market value. On the contrary, LIFO recapture is defined as the difference between the LIFO basis and the FIFO basis.

What about the situation where the fair market value of the inventory in fact is less than the FIFO value of that inventory? To tax this different would be taxing gain where there is no real gain.

Four, there is no reference in the determination of FIFO to the difference between the FIFO cost and the lower of FIFO cost or market. I believe this point needs to be addressed.

Five, another technical problem relates to determining the LIFO value of individual items. The most common method of LIFO is dollar value LIFO, which determines the LIFO value of a pool. But we would need to know the dollar value of specific items in order to apply the statute as it is presently drafted.

Six, there has been commentary submitted about the adverse effect on small business. I would simply like to reemphasize that this recapture provision of LIFO—and again I can say from my own experience—will affect the small business, whereas the large business has other ways of avoiding the recapture provision.

Seven, the tax section of the ABA has commented on the retroactive effect, and with those comments I agree.

And finally, in terms of the effect on revenues a comment has already been made to the effect that most taxpayers that are going to liquidate have already adopted plans of liquidation. I believe that is true. Perhaps the only ones who have not will be the unwary or unsophisticated taxpayers who do not have the benefit of tax advisers, and they may be the ones who will be trapped if the effective date is not postponed. And I do not think that that represents a significant impact on revenues.

I thank you.

[The prepared statement follows:]

STATEMENT OF WILLIAM R. SUTHERLAND, MEMBER, TAX ACCOUNTING SUBCOMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STATEMENT SUPPORTING DEFERRAL OF EFFECTIVE DATE OF SECTION 403(b) OF CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

Section 403(b) of the Windfall Profit Tax Act is generally referred to as the "LIFO recapture" provision. This appears as Section 336(b) and 337(f) of the Internal Revenue Code. In the case of distributions of inventory assets by a liquidating corporation it requires recognition of taxable income to the extent of the excess of the FIFO basis over the LIFO basis of the inventory assets distributed. This law applies to liquidations undertaken pursuant to a plan of liquidation adopted after December 31, 1981.

It is the AICPA's position that this provision of the law should be repealed. The purpose of this statement, however, is to support a deferral of the effective date, so that hearings can be held to consider the merits of the provisions. The Conference Committee Report on the original law discloses "the effective date was postponed to allow time for Congressional hearings on this provision."

To date, hearings have not been held on the merits of this provision. It is the AICPA's position that the result of this provision may be unintended in some cases, that there are technical uncertainties in the law, that the law appears to be inconsistent with tax policy on similar matters, that the law poses inequitable consequences to small businesses, and generally that the law unreasonably discriminates against all LIFO taxpayers. The AICPA believes the merits of these concerns must be considered in a Congressional hearing. Furthermore, the Economic Recovery Tax Act of 1981 directs Treasury to conduct a full and complete study of inventory matters with a view towards simplification. At a minimum we urge deferral of the effective date of the LIFO recapture provision until Congress has received this report and considered the merits of inventory reform.

In order to support our position that deferral of the effective date is necessary, this statement will identify and briefly explain several problems we see in the recapture provision, as follows:

1. AS A MATTER OF TAX POLICY WHY SHOULD CONGRESS SINGLE OUT LIFO INVENTORIES FOR DOUBLE TAXATION OF UNREALIZED APPRECIATION ATTRIBUTABLE TO INFLATION?

The LIFO recapture provision changes the basic pattern of taxation of corporate liquidations by taxing the unrealized appreciation in a single asset at both the corporate and shareholder levels. Inventories alone have been singled out for this change in treatment, with unrealized appreciation in other assets continuing to be taxed only at the shareholder level. Normally, when a corporation liquidates, Section 336 provides that the appreciation in value of corporte assets is recognized at the shareholder level and not at the corporate level. Section 336, which has been in effect since 1954, was intended to provide simple, consistent tax treatment of liquidations and to reduce the level of taxation in liquidations. The double taxation of unrealized appreciation in inventories is contrary to these desirable objectives of tax policy.

The double taxation of unrealized appreciation in inventories is particularly offensive in that it is clearly taxing inflationary gain rather than real economic gain. In addition to the apparent unfairness of such a tax, it runs counter to the increasing interest in Congress, in the Administration, and in the business community for tax reforms in the inventory area.

2. LIFO IS AN ACCEPTABLE METHOD OF DETERMINING COSTS—IT IS NOT A LOOPHOLE, A SPECIAL ALLOWANCE, OR A TAX EXPENDITURE

LIFO is commonly used for tax and financial reporting purposes. It is a method of determining the cost of inventory on hand for balance sheet purposes, and the matching of a flow of such costs against revenue for income statement purposes. In an inflationary economy this matching process should not be misinterpreted as merely a deferral of taxable income. In an inflationary economy LIFO might reduce both financial and taxable income by removing inflation related profits from such income. The recapture provision presently on the books fails to recognize this important distinction.

The LIFO recapture provision does not affect other methods of inventory accounting such as specific identification or average cost, which could reduce the tax basis of inventories below FIFO costs. Such inconsistent and discriminatory treatment would appear to be wrong on its face.

Once LIFO is correctly understood in this context it is readily apparent that the "LIFO recapture amount" is conceptually different from depreciation recapture. Yet, in the haste of wrapping up the Windfall Profit Tax legislation it appears that Congress may not have recognized the real difference.

3. TAXATION OF NONEXISTENT GAIN

The LIFO recapture provision is sometimes compared to depreciation recapture under IRC Section 1245. There is a difference in the measure of the recapture amount under the two recapture provisions: the LIFO recapture amount is the excess of the FIFO basis over the LIFO basis of inventory assets distributed in liquidation, whereas the depreciation recapture amount is limited to the excess of the fair market value over the adjusted basis of section 1245 property distributed in liquidation (See IRC Section 1245) (a)(1)(B)(ii)). Thus, depreciation recapture is limited to actual economic gain. The LIFO recapture amount can exceed actual economic gain. The FIFO basis of inventory, particularly in a liquidating situation, could easily exceed the fair market value of such inventory. To tax a "LIFO recapture amount" based on tax basis of FIFO inventory could create taxable income when in fact no economic gain exists. We question whether Congress intends such a result.

4. HOW IS FIFO BASIS TO BE DETERMINED, REGARDING ALLOWABLE MARKET WRITEDOWNS?

LIFO and FIFO are methods of determining cost. A taxpayer using LIFO is not entitled to value inventory below LIFO cost, even if legitimate market writedowns were otherwise allowable. A taxpayer using FIFO may adopt a tax accounting method of valuing inventory either at FIFO cost, or at the lower of FIFO cost or market. Either method, once adopted by a FIFO taxpayer, would require IRS permission for a change to the other method. The LIFO taxpayer is never confronted with a need to make such a choice of allowable FIFO methods. Section 336(b)(3)(A) refers only to "the first-in, first-out method authorized by Section 471". We do not believe Congress intends to disallow a proper market writedown for this purpose. However, the law doefs not address this point and we believe there is a risk of strict intrepretation since the law makes no reference to the lower of FIFO cost or market.

5. WHAT IS THE LIFO BASIS OF INVENTORY ASSETS COMPRISING LESS THAN THE WHOLE OF A DOLLAR VALUE POOL?

The most common LIFO method is "dollar value LIFO". In this method the LIFO value of a pool of inventory items is determined, but the LIFO value of individual items is not determined. In this case, how would the LIFO value of a group of inventory items comprising less than the whole of a pool be measured—i.e., what if the inventory items distributed in liquidation comprised less than the entire pool? This may sound like a technicality but it is a real problem and should be addressed.

6. PARTICULARLY ADVERSE EFFORT ON SMALL BUSINESSES

The LIFO provision will have a particularly adverse impact on small businesses. A frequent use of the Section 337 liquidation provision is to provide liquidity in the estate of the owner of a small business. The double tax will frustrate this objective but will not affect larger businesses because of the marketability of their shares and the normally better access to other sources of financing. In seeking to avoid the impact of the LIFO recapture provision, small businesses may be encouraged to merge into larger businesses in tax-free transactions. The recapture provision does not apply to other types of liquidations and reorganizations, but the result will be that small businesses in many cases will lose their identity and become part of larger corporations.

7. RETROACTIVE EFFECT

The provision applies to the full LIFO recapture amount even though the amount may have accumulated over many years prior to enactment. Generally such changes are not made retroactively, and the lack of grandfathering or other relief may not have been intended.

8. EFFECT ON REVENUES

It is the AICPA's belief that a deferral of the effective date will not have a significant effect on revenues. Taxpayers contemplating a liquidation in the foresee-

able future will adopt plans of liquidation on or before December 31, 1981. Thus, the tax revenues potentially to be lost from deferral will no doubt come from the unwary or unsophisticated taxpayers—probably consisting primarily of smaller businesses who do not effectively use professional tax advisers.

CONCLUSION

A deferral of the effective date of the LIFO recapture provision is necessary in order to allow time for hearings on its merits. To the extent the problems described herein describe technical interpretations, which possibly could be handled in regulations, we believe such technical problems are of such substance that they raise doubts whether the law is conceptually sound. To the extent that the problems may be a matter of tax policy, we believe the policies have not been fully considered. Our legislative process does not contemplate creation of laws without first undertaking the deliberative and thoughtful process afforded by Congressional hearing.

Mr. GIBBONS. Thank you, sir.

I thank the panel. And unless there are questions at this point, the committee will adjourn long enough to vote, and we will be right back for the next panel. If the next panel would come forward and take their position, we will be back as soon as we can.

[Recess.]

Mr. GIBBONS. The committee will resume.

Mr. Nolan, go ahead.

STATEMENT OF JOHN S. NOLAN, COUNSEL, AD HOC COMMITTEE FOR PROPER TAXATION OF BUSINESS INVENTORY

Mr. NOLAN. Thank you.

I appear in strong support of H.R. 4717 and H.R. 5011 to defer for 1 year the provision that would tax the inflationary gain in LIFO inventory on liquidation of a corporation. I appear for the Ad Hoc Committee for Proper Taxation of Business Inventory, which is a group of small businesses throughout the United States.

When this so-called LIFO recapture provision was first enacted in the Windfall Profits Tax Act of 1980, it appeared first as a Senate floor amendment, suggested by the Treasury Department, without any warning or notice to the small business community. There were no public hearings, and to my knowledge, this proposal had never even been debated heretofore by tax reform proponents in the frequent public forums on tax reform measures. It came "out of the blue." As a result, its effective date was deferred until 1982 for the express purpose, stated in the conference report, of allowing time for congressional hearings on the merits of the idea.

Those hearings have never been held. Small business has never been given an opportunity to explain the extraordinary, adverse effects and inequity of the provision to this committee. There can be no reason whatsoever under these circumstances for failing to defer the effective date of the provision for 1 year and proceeding early next year to hold hearings on its merits.

The importance of these hearings must be recognized. The provision in question imposes a double tax on inflationary gain in inventory at the time of liquidation of a corporation. This is directly contrary to the general policy of the Internal Revenue Code to tax gain in liquidation only once. The provison operates to tax this inflationary gain as ordinary income at the corporate level as well as taxing it as capital gain at the shareholder level. The provision includes in the gain which is taxed the entire amount of inflation-

ary gain since the time the small business first adopted the use of LIFO inventories; this may include inflationary gain which arose long before the provision in question was enacted in 1980.

This extraordinary double tax burden in most cases will drastically reduce the value of the business to its owners. Instead of being free to sell the business at any time to the highest bidder, the owners will be under great pressure if they need to dispose of their business to transfer it in a tax-free merger to a publicly held company.

The key to understanding the effect of this provision is to recognize that if there were no inflation, there would be no taxable gain. Thus, the tax is purely one on an inflationary gain. The policy of our existing tax system is clear—ordinarily we do not tax gains at the corporate level in liquidation of a corporation; the tax is imposed only once at the shareholder level as a consequence of the liquidation. An exception is made for recapture of depreciation, but that is a special case. The gain there may be a real gain, not an inflationary gain, and the tax is merely the recapture of a tax benefit—the depreciation taken. This is not true with respect to LIFO recapture. LIFO is merely a method of identifying inventory costs to be associated with the sale of goods. Inventories for the most part are fungible, and it is as reasonable to treat the cost of the goods most recently purchased as being the cost of the goods currently sold, as is done under LIFO, as it is to make any other assumption as to the flow of costs. Accordingly, the taxpayer has obtained no tax benefit as a result of using LIFO which is being recaptured, which is true in the case of depreciation recapture. Instead, the gain that will be taxed is purely the appreciation in value of the taxpayer's inventory resulting from inflation.

The principal adverse effect of the LIFO recapture rule will be on small business companies. The provision will result in further concentration of small business into publicly held companies.

There will be no significant revenue loss from deferring the effective date of this provision for 1 year. Under existing law, well-advised companies can avoid its effect for 1 full year, and the provision will thus become a trap for the unwary in 1982.

Business taxpayers are entitled to a hearing on the merits in this provision, and accordingly, H.R. 4717 and 5011 should be favorably reported by this committee.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN ON BEHALF OF AD HOC COMMITTEE FOR PROPER TAXATION OF BUSINESS INVENTORY

H.R. 4717 AND H.R. 5011—TO DEFER THE EFFECTIVE DATE OF SECTION 403(B) OF THE WINDFALL PROFIT TAX ACT OF 1980, RELATING TO THE TAXATION OF CERTAIN LIFO INVENTORY AMOUNTS

My name is John S. Nolan. I am testifying in support of H.R. 4717 and H.R. 5011 on behalf of the Ad Hoc Committee for Proper Taxation of Business Inventory. The Ad Hoc Committee is composed of a group of closely-held companies scattered throughout the United States. These companies and others similarly situated will be adversely affected if the so-called LIFO Recapture Provision is allowed to go into effect.

This tax provision was added to the Internal Revenue Code by section 403(b) of the Windfall Profit Tax Act of 1980. It originated as a Senate floor amendment without the benefit of public hearings. The House-Senate conferees accepted the

provision as an amendment to the Act, but with the significant qualifications that it be effective only for distributions and dispositions made pursuant to plans of liquidation adopted after December 31, 1981. The Conference Report makes this explanation: "The effective date was postponed to allow time for Congressional hearings on this provision." See House Rept. No. 96-817, 96th Cong., 2d Sess. 161 (1980).

The provision will become effective on January 1, 1982, but with the press of other business, Congress has not yet had an opportunity to hold hearings on the merits of the provision. H.R. 4717 and H.R. 5011 are essentially routine bills fully consistent with the original intent behind the addition of the provision to the Code. These bills would defer the effective date of the provision an additional year to allow time for the hearings to be held and for Congress to take necessary corrective action.

Although the purpose of the hearing today is to consider H.R. 4717 and H.R. 5011 and whether the effective date of the LIFO Recapture Provision should be deferred, it must be noted that the members of the Ad Hoc Committee favor repeal of the provision. From a tax policy standpoint, the provision is unsound. It should be repealed; it should not be allowed to go into effect.

The provision would apply where a corporation using the LIFO inventory method liquidates, except for tax-free liquidations under section 334(b)(1) of the Code. Specifically, it would apply in the case of a sale by the corporation of its LIFO inventory under section 337 in liquidation, or upon the distribution of its LIFO inventory to the shareholders under section 336 in liquidation.

The provision requires the corporation to recognize as ordinary income the amount of its "LIFO reserve." The LIFO reserve is the difference between the cost of the corporation's inventory under the LIFO (last-in, first-out) inventory method and what would be the cost of its inventory had it used the FIFO (first-in, first-out) inventory method. In all of the liquidations to which the provision will apply, the shareholders will recognize gain either in the liquidation or upon sale of their stock to a purchaser who would liquidate the corporation under section 334(b)(2).

The provision singles out LIFO inventories for this treatment. It does not apply where the lower-of-cost-or-market method is used in connection with the FIFO method, where the average-cost inventory method is used, or where the specific-identification inventory method is used.

We are all aware that the LIFO inventory method is an accepted method of accounting for inventories. Many regard it as the preferred method for measuring business income because it matches current costs with current revenues. When a corporation sells its assets and liquidates, or merely distributes its assets to the shareholders in liquidation, the provision would tax only the inflation-induced gain inherent in its LIFO inventory. By singling out LIFO, it does not apply to the inflationary gain inherent in the other assets of the business.

As noted earlier, the provision would impose this tax in addition to the tax at the shareholder level. The provision therefore runs counter to the policy of the Internal Revenue Code adopted in 1954 that gain on liquidation of a corporation should be taxed only once. If the provision is to be allowed to go into effect, it raises substantial questions as to whether sections 336 and 337 should be continued or substantially modified.

Even though there would be no tax under the provision if there were no inflation, the provision fails to grandfather the inflationary gain arising before its effective date. This is particularly unfair to businesses which have employed the LIFO inventory method for a number of years in that the provision would reach the inflationary gain accumulated over these years.

The proponents of the provision draw a parallel between it and the depreciation recapture provisions which apply in the case of liquidation transactions under sections 336 and 337. I submit that whatever appeal this parallel may have from a cursory examination of the provision, it is misplaced. The hearings on the merits of the provision will bring this out. The point, briefly made, is that when an asset is depreciated, it is retained in the business while its cost is written-off. An inventory is a collection of many individual units and the LIFO inventory method is merely a system of sequencing the costs of the units which are sold. Those inventory units which are retained in the business are carried at cost under the LIFO inventory method; they are not written below cost. Thus, LIFO inventory items are more closely related to the other assets of the business which are not depreciated but are carried at cost. The gain on these other assets, regardless of the accumulated inflation or retention policy of the corporation, is not recognized under sections 336 and 337.

If this provision becomes effective, its principal adverse impact will be on small, closely-held businesses. The mere threat that it will become effective in 1982 is already causing many closely-held businesses to consider accelerating their plans to

sell out. Once effective, the provision will encourage small businesses to be acquired by large businesses in tax-free transactions. Large corporations which continue indefinitely and are not liquidated are unaffected by the provision. The provision will encourage the further concentration of small businesses into larger ones, and a decreased significance of closely-held businesses in our economic system. If the provision is to be retained, this result must be examined at the hearings on the merits of the provision.

It is doubtful that the estimates of the large revenue losses attributable to repeal will materialize. Revenue estimates are typically based upon static conditions without regard to what taxpayers may do to avoid impact of a new tax provision. Many taxpayers facing the provision are apt to negotiate tax-free transactions with large businesses to avoid application of the provision, rather than negotiated taxable transactions. Such transactions would have another result of avoiding the capital gains tax at the shareholder level. Here, the provision would produce less revenue than present law. Some companies may choose not to liquidate at all.

Another point which should be made here is that any revenue gain which may be produced by the provision should not be considered as lost revenue if the provision is repealed. The House-Senate conferees contemplated hearings on the provision before it was to take effect; it is presumptuous to count the revenue from a provision for which the proponents may fail to make a case.

Returning to the H.R. 4717 and H.R. 5011, however one views the overall revenue issue, the revenue loss from deferral of the provision for an additional year will not be great. Companies with large LIFO reserves anticipating liquidation are free to adopt and will adopt plans of liquidation before the end of 1981 under the existing effective date of the provision. They will be free to liquidate next year and avoid application of the provision.

The essential point to be made today is that, as the House-Senate conferees recognized when the provision was added to the Code, taxpayers are entitled to have a hearing on the merits of the provision before it becomes effective. H.R. 4717 and H.R. 5011 would enable them to have this opportunity and at the same time would result in little or no revenue loss to the Treasury. I urge the Committee to defer the effective date of the provision for an additional year and to promptly schedule hearings early next year on the merits of the provision.

Mr. GIBBONS. Thank you, Mr. Nolan.

Next we have the Chamber of Commerce of the United States, director of the tax policy center, David Franasiak.

STATEMENT OF DAVID E. FRANASIAK, DIRECTOR, TAX POLICY CENTER, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. FRANASIAK. I appreciate this opportunity to strongly support the passage of H.R. 5011 and H.R. 4717.

On behalf of our over 200,000 businesses, trade associations, local and State Chambers of Commerce, I commend the committee's decision to hold this hearing and urge the Congress to consider speedy passage of these measures with an eye toward holding hearings on the merits of the LIFO recapture issue early in the next session.

I particularly want to thank all those Congressmen who signed Mr. Gradison's letter to Mr. Rostenkowski. I also want to thank the minority chairman, and in particular I would like to thank the staff members of the full committee and the individual members staffs. They have been very accessible and very understanding on this somewhat complex issue.

First of all, let me point out that the U.S. Chamber of Commerce is predominantly a small business association. Over 90 percent of our business members employ less than 100 employees. When one talks about revenue loss on this provision, one is primarily talking about the revenue loss that the smaller firms are going to incur, and indeed, this is a great blow to them because they cannot plan. They do not have the staff, and they do not have the ability to be

able to plan a liquidation or a spinoff. Many times they are forced into liquidation. This is a point that I think is very important, and many of the committee members have brought this up.

I also agree with the previous witness' statement regarding the intent of Congress in postponing the effective date, and I am sure that that is recognized by almost all the members of this committee.

In addition, I might add that the Economic Recovery Tax Act of 1981 contained several provisions which hopefully will make it easier for smaller firms to use LIFO. If we would allow this provision to go into effect, it would be counter to the intent of ERTA. In addition, ERTA also suggested or actually compelled or requested that Treasury complete a study on inventory accounting, including all its aspects, and comment on how it may be made simpler to enable small firms to use LIFO.

That study is due by December 31, 1982, and certainly the Treasury wanted that date in ERTA because they realized it would take a fair amount of time to understand the issue totally. It seems unusual that they would want the LIFO recapture provision to go into effect while at the same time be willing to ask for an extended length of time in order to complete this study.

I might also add that there are other sections of the code where certain effective dates will go into effect at the beginning of 1982. The Treasury has agreed in these areas—and I am specifically referring to section 382—they that it would be proper to defer the effective date for 2 years, and I would argue that the issues present there are very similar to the issues here.

That is all I wish to say. I would like to see my entire statement entered into the record.

Mr. GIBBONS. Certainly, it will be. The statements of all the panel will be.

[The prepared statement follows:]

STATEMENT OF DAVID E. FRANASIAK, ESQ., CHAMBER OF COMMERCE OF THE UNITED STATES

I am David E. Franasiak, Director of the Tax Policy Center for the Chamber of Commerce of the United States and am accompanied by Rachelle Bernstein, Senior Tax Attorney at the Center. I appreciate this opportunity to support strongly the passage of H.R. 5011 and H.R. 4717. Both bills would amend Section 403(b) of the Windfall Profit Tax Act of 1980 (Public Law 96–233) to defer the effective date of the LIFO (Last-In, First-Out) inventory accounting method recapture provision for one year, until December 31, 1982. On behalf of our over 200,000 business, trade association and local and state chamber members, I commend the committee's decision to hold this hearing and urge the members to consider speedy passage of these measures with an eye toward holding a hearing on the merits of the LIFO recapture issue early in the next session.

BACKGROUND

The LIFO recapture provision was added to the Windfall Profit Tax Act of 1980 as a Senate floor amendment and was a compromise between the sponsoring Senators and the Treasury Department. The Treasury agreed not to challenge the first part of the amendment, Section 403(a) of the Act, if the Senate sponsors would accept the LIFO recapture provision. Section 403(a) provides that LIFO inventory profits will not be recognized if inventories were liquidated in response to a Department of Energy regulation or request or because of a major foreign trade circumstance and if the taxpayer purchases replacement inventory within three years.

Despite its broad application to the business community at large, the LIFO recapture provision was developed by the Treasury Department without the benefit

of public hearings by the tax committees and without extensive floor debate. The House-Senate conferees recognized the potential impact of the LIFO recapture provision and the lack of congressional inquiry and agreed, as a result to delay the effective date until December 31, 1981 to allow hearings to be held. To date, none have been. At least twenty members of the Ways and Means Committee, including Representatives Willis Gradison and Ed Jenkins, have supported a one year deferral of the LIFO recapture provision in order to allow the committees and Congress time to consider the merits of the issue. A majority of the members of the Senate Finance Committee support identical legislation.

THE EFFECT ON THE BUSINESS COMMUNITY

LIFO recapture will greatly affect corporations which use LIFO. Under the provision, a corporation that has been using the LIFO method of accounting, and which is sold or liquidated pursuant to plans of liquidation adopted after December 31, 1981 will be required to pay a tax. The tax will be imposed upon an amount equal to the difference between the tax basis of its LIFO inventory and what would be the tax basis had it used FIFO (First In, First-Out).

The LIFO recapture provision is bad tax policy and should be repealed or, at the very least, modified. In any event this provision should be deferred until the Congress has the opportunity to consider its effect on the business community. Briefly, if enacted LIFO recapture would:

Result in double taxation—once at the corporate level and once at the shareholder level;

Depress the value of inventories of corporations which use LIFO;

Encourage corporations to enter into stock-for-stock transactions as opposed to installment contract sales and cash sales of corporate assets;

Discriminate against LIFO versus other non-FIFO methods, such as the average cost method;

Discriminate against the corporate form of ownership;

Apply retroactively to LIFO benefits for years before the date of enactment;

Tax inflationary gain rather than real economic gain;

Penalize smaller corporations which do not have the benefit of highly trained tax professionals; and

Discourage the use of LIFO.

This listing is necessarily brief because the focus of today's hearing is deferral, as opposed to repeal, of LIFO recapture. We would be pleased to furnish the Committee with a more complete analysis of the issue.

A NOTE ON REVENUE GAIN

A one year delay of LIFO recapture will result in minimal revenue loss to the Treasury. We understand that many businesses are planning to adopt plans of liquidation before December 31, 1981, or have already adopted plans of liquidation pursuant to Sections 336 and 337 of the Internal Revenue Code and will not be affected by LIFO recapture. As a result, the revenue gain in calendar year 1982 associated with enactment of LIFO recapture will be minimal at best.

CONCLUSION

The LIFO recapture provision has already cost the business community a great deal of time, concern and money. Many firms have incurred substantial accounting and legal fees in an attempt to deal with the adverse effects of this provision. Smaller corporations may not recognize the effect that LIFO recapture will have on their businesses until they try to sell them.

The enactment of the LIFO recapture provision without congressional hearings would not result in sound tax policy. Congress recognized this when it agreed to delay the effective date in order to allow the relevant committees time to consider the issue. We strongly urge the committees and Congress to defer the effective date for one year to allow time to consider this important matter.

Mr. GIBBONS. Mr. McKevitt, you may proceed.

STATEMENT OF JAMES D. "MIKE" McKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. McKEVITT. Mr. Chairman and Mr. Conable, let me make it very quick.

We support what everyone on the panel supports. We agree with them. We think there should be an extension, No. 1.

No. 2, the 1981 Tax Act said that—it directed Treasury to look at the whole problem of inventory reform, including cash accounting and simplification of LIFO. We would hope that when you have these hearings in the future that you include the package of inventory reform in general. It would be a great help to small business.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JAMES D. "MIKE" MCKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, I am Mike McKevitt, Director of Federal Legislation for the Natioal Federation of Independent Business (NFIB), and accompanying me today is Abraham Schneier, Tax Counsel with our Research Department staff. On behalf of our membership, which is in exess of 500,000 small and independent businesses, I am here to present our members' point of view on the proposal before you, which would defer the effective date of the LIFO recapture amendment enacted as a part of the Windfall Profits Tax Act of 1980 (WPT).

Small business generally does not use the LIFO method of accounting because of the tremendous complexities involved in the adoption and utilization. On this basis the LIFO recapture amendment would normally be of no concern to small business.

However, the Economic Recovery Tax Act of 1981, and the alternative tax reduction proposal which was offered by this committee, called for the Treasury Department to study the entire area of inventory and accounting methods. Smaller firms are placed at a substantial competitive disadvantage relative to larger firms because they are unable to utilize certain inventory and accounting methods which might effect substantial savings.

The Secretary of Treasury is directed to conduct a full and complete study of inventory and accounting methods with a view towards development of simplifications. On this basis it would seem proper, in our opinion, that hearings should be held to determine if LIFO recapture, as it was proposed in the Windfall Profits Act of 1980, is warranted in light of possibly major changes to the LIFO method. Hearings on the LIFO recapture amendment were recommended by the Conference Report which accompanied the Windfall Profits bill, because Congress had very little opportunity to review this amendment.

Certainly as time has gone by, more and more questions have been raised as to the fairness of the LIFO recapture amendment and as to the fundamental changes in tax policy which this "technical amendment" makes. Small business' concern is that if simplification of inventory and accounting methods are to be considered, including simplification of LIFO method so that finally small business may utilize LIFO, then LIFO recapture needs to be reviewed. Otherwise it is possible that this rule could remove the potential benefit of electing LIFO for many small firms.

To summarize, NFIB shares the opinions of the other members of this panel that a one year deferral of the LIFO Recapture Amendment is justified and warranted. This committee should propose a date for hearings to be held on the merits of the issue at the earliest possible date.

This hearing is necessary due to the variety of equity issues involved in this proposal and the possibility that inventory reform may largely become a futile exercise if some of the effects of the amendment come to pass.

Thank you, Mr. Chairman. I am available for any questions you may have.

Mr. GIBBONS. Thank you, Mike.

I am sure you did not want to overlook the sponsor of this bill, who sits over here.

Mr. McKEVITT. I certainly do not, Mr. Jenkins, and we thank you very much, sir. I am sorry. I did not see you come in.

Mr. GIBBONS. He is always here, one of our most reliable.
Mr. MCKEVITT. Amen.
Mr. GIBBONS. Mr. Zakupowsky.

STATEMENT OF ALEXANDER ZAKUPOWSKY, JR., PARTNER, DELOITTE HASKINS & SELLS

Mr. ZAKUPOWSKY. Thank you.

My name is Alexander Zakupowsky. I am a partner in Deloitte Haskins & Sells, an international public accounting firm. I welcome this opportunity to testify before you today in support of the legislation, which if enacted will defer the effective date of the so-called LIFO recapture provisions of the Crude Oil Windfall Profit Tax Act.

I will skip a recitation or explanation of the provision, but I would like to stress that the burden of this tax, if it goes into effect, will fall primarily upon the owners of small business, at least in the short term; and that for a number of sound technical and policy reasons the increment between LIFO and FIFO should not be added to the existing limited number of exceptions to the general rule that no gain or loss must be recognized by a corporation on the distribution of property in partial or complete liquidation. We look forward to future hearings to discuss the merits of these considerations, but today limit our remarks to the issue of deferral.

The sections of the Internal Revenue Code affected were the subject of very serious congressional review in 1954. After careful consideration they were enacted into law. We are not aware of any change in circumstance which leads us to believe at this time that the congressional committees which reviewed the legislation in 1954 would change their decision.

Moreover, the Internal Revenue Service has looked at the issue of LIFO recapture in a recent ruling, and we believe has correctly concluded that the recapture provision should not apply to LIFO deferral.

As a matter of sound tax policy, it is inappropriate for changes to be made to well-established principles of law which were carefully considered and adopted by a prior Congress and which taxpayers have functioned under for a number of years, unless the merits of the proposed change have been fully considered by the appropriate legislative committees.

This consideration should afford interested taxpayers an opportunity to be heard on the substance of the issue. The provision in question escaped this process, since it was offered and adopted as a nongermane amendment on the Senate floor, as has been pointed out by previous witnesses.

In support of our position that sound tax policy requires thorough legislative consideration of the issue before it becomes effective, I would like to quote from a letter sent to us by Senator Russell Long, then chairman of the Senate Finance Committee, in response to our early objections to the LIFO recapture provision once it was adopted on the Senate floor. I quote from Senator Long's letter:

> Those of us who were Senate conferees on H.R. 3919, the Crude Oil Windfall Profits Tax Act, have received a great deal of correspondence criticizing this provi-

sion. There have been objections both to the merits of the provision from a tax accounting standpoint and to the fact that it was adopted without hearings or committee consideration as an amendment at the tail end of Senate floor action.

In view of these objections, it is clear that there should be an opportunity for thorough legislative consideration of the subject prior to the change taking effect. Consequently, the House and Senate conferees, have decided to defer the effective date of this provision so that it will apply only to plans of liquidation adopted on or after January 1, 1982.

Unfortunately, other priorities of this committee and the Senate Finance Committee have prevented a substantive review of the provision. I think in view of this and what other witnesses have said, we have a very good case for a delayed effective date on the so-called LIFO recapture provision.

Thank you, Mr. Gibbons.

[The prepared statement follows:]

STATEMENT OF ALEXANDER ZAKUPOWSKY, JR., PARTNER, DELOITTE HASKINS & SELLS

SUMMARY OF PRINCIPAL POINTS

The LIFO recapture provisions of the Crude Oil Windfall Profits Tax Act of 1980 will impose a tax on many corporations, that pursuant to a plan of liquidation, distribute or dispose of inventories valued under the Last-In, First-Out (LIFO) method. In many cases the burden will fall upon the owners of small-closely held businesses.

The provision was added on the Senate floor, witout hearings or committee consideration and was completely unrelated to the subject matter of the Crude Oil Windfall Profits Tax Act.

Congress believed that a two year delay in the effective date would allow sufficient time to hold hearings and address the merits of this significant change. However, other priorities have kept the issue off the agenda of the tax writing committees.

Conclusion.—It is appropriate to defer the effective date of the LIFO recapture provisions for an additional year to allow time for hearings and Congressional consideration of the issue.

STATEMENT

My name is Alexander Zakupowsky, Jr. I am a partner in Deloitte Haskins & Sells, an international public accounting firm. I welcome this opportunity to testify before you today in support of H. R. 4717 and H. R. 5011 which, if enacted, will defer the effective date of the so-called "LIFO recapture provisions" of The Crude Oil Windfall Profits Tax Act of 1980.

Under these provisions of the Act, a tax will be imposed on many corporations, that pursuant to a plan of liquidation, distribute or dispose of inventories valued under the Last-In, First-Out (LIFO) method. This tax would generally be based on a hypothetical gain equal to the difference between the LIFO cost of the inventory and the cost of the inventory had the First-In, First-Out (FIFO) method of valuing inventory been used. In many cases the burden will fall upon the owners of small-closely held businesses.

As a general rule the Internal Revenue Code provides that no gain or loss will be recognized by a corporation on the distribution of property in partial or complete liquidation. Instead, the gain is taxed at the shareholder level or deferred through a carryover basis mechanism. The purpose of this rule is to avoid the taxation of the same gain at both the corporate and shareholder levels. However, there are a limited number of statutory and judicial exceptions to this general rule that apply to recapture the benefit of prior deductions in situations where the basis of the assets does not carry over. For example, sections 1245 and 1250 recapture excess depreciation deductions. For a number of sound technical and policy reasons the increment between LIFO and FIFO should not be added to the limited number of exceptions. We look forward to future hearings to discuss the merits of these considerations but today limit our remarks to the issue of postponing the effective date of the LIFO recapture provisions.

The sections of the Internal Revenue Code affected were the subject of congressional review in 1954. After careful consideration, they were enacted into law. We

are not aware of any change in circumstances which leads us to believe that, if given the opportunity to do so, the Congressional committees which reviewed the legislative proposals in 1954 and recommended their enactment would reach a different conclusion today.

Moreover, the Internal Revenue Service has more recently considered the question of whether a liquidation corporation disposing of inventory valued under the LIFO method has recieved a tax benefit which must be recaptured. They correctly concluded tht it had not. I refer yuou to Revenue Ruling 74-431, 1974-2 CB 107.

As a matter of sound tax policy it is inappropriate for changes to be made to well established principles of law which were carefully considered and adopted by a prior Congress, unless the merits of the proposed change have been fully considered by the appropriate Congressional committees. This consideration should afford interested taxpayers an opportunity to express their views. The provision in question escaped this process, since it was offered and adopted as a non germane amendment on the Senate floor.

In support of our position that sound tax policy requires thorough legislative consideration of this issue before it becomes effective, I would like to quote from a letter sent to us by Senator Russell Long, then chairman of the Senate Finance Committee, in response to our objections to the LIFO recapture provisions:

"Those of us who were Senate conferees on H.R. 3919, the Crude Oil Windfall Profits Tax Act, have received a great deal of correspondence criticizing this provision. There have been objections both to the merits of the provision from a tax accounting standpoint and to the fact that it was adopted, without hearings or Committee consideration, as an amendment at the tail end of Senate floor action.

"In view of these objections, it is clear that there should be an opportunity for thorough legislative consideration of the subject prior to the change taking effect. Consequently, the House and Senate conferees have decided to defer the effective date of this provision so that it will apply only to plans of liquidation adopted on or after January 1, 1982."

Unfortunately, other priorities of this committee and the Senate Finance Committee have prevented a substantive review of the provision.

In view of the absence of hearings and careful committee consideration of the LIFO recapture provisions and the original action of the Congress providing for a deferred effective date to allow an opportunity for such consideration, it is appropriate at this time to further delay the effective date of this significant change for an additional year to allow time to review the substantive merits of the issue.

Mr. GIBBONS. Any questions?

Mr. CONABLE. The only question I have is that there is no public policy against taxing inflation. We obviously tax inflation. With respect to capital gains we try to minimize it by reducing the rate. We have tried to reduce the taxation of inflation with respect to depreciation by shortening the term. We do not index inflation out of other areas of taxation. But there is not any reason for us to extend the principle by taxing inflation in this case. I would like to see us eventually have a system that would tax real appreciation rather than something that results from inflation.

There is no doubt that you can get an appreciation in inventory without inflation, but that is the exception rather than the rule. So we ought to base our policy in this case on trying to reduce the taxation of something more likely to be inflation than anything else. That is the reason that I am supporting Mr. Jenkins' proposal. And I do think that we sometimes tend to overstate the arguments, but there is no question about it in this case in my view that substantial justice is served by deferral at least.

That is all I want to say.

Mr. NOLAN. Could I add to that, Mr. Conable? Your comments get right to the heart of this issue, because it is absolutely clear, and the Treasury does not suggest otherwise, that the gain of a FIFO taxpayer in a corporate liquidation is not taxable.

The gain of a FIFO taxpayer could conceivably reflect some real gain. The company could have processed its inventory and there

could have been value added by the labor input of the company. That gain is not taxable and will not be taxable. It makes no sense whatsoever to single out the LIFO inventory taxpayer and tax it when such FIFO gain is not taxed. The fundamental policy of the Internal Revenue Code is not to tax gains twice upon liquidation. Here, we have none of those ameliorative provisions that you mentioned. The full gain will be taxed as ordinary income at the corporate level, and it will then be taxed again at the shareholder level. There is no policy that justifies this treatment.

Mr. CONABLE. It is my impression that Treasury, faced with an issue of this sort where there is precedent on both sides, in all probability tends to resolve the issue in favor of recapture wherever possible. That does not mean that we are bound by their resolution of the issue.

Mr. GIBBONS. Mr. Jenkins.

Mr. JENKINS. Mr. Chairman, I have no questions. I want to thank the panel for their excellent testimony.

Mr. GIBBONS. I thank the panel, and we appreciate your coming.

Our next panel is Denis R. Zegar, director, government services, National American Wholesale Grocers' Association; John H. Fitch, Jr., vice president for government relations, National Association of Wholesaler-Distributors; James M. Goldberg, counsel, National Shoe Retailers Association, National Lumber & Building Material Dealers Association, National Association of Retail Dealers of America; and Jerome K. Grossman, Murdoch & Walsh, P.A., Wilmington, Del.

Mr. Zegar, you may proceed, and the entire statements of each of the panel members may be included in the record.

STATEMENT OF DENIS R. ZEGAR, DIRECTOR, GOVERNMENT SERVICES, NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. ZEGAR. Thank you.

On behalf of the National-American Wholesale Grocers' Association, it is a pleasure to appear before you today to express the view of NAWGA on this important issue of LIFO recapture.

I would just like to briefly summarize my remarks by saying at this time that NAWGA strongly urges the committee to delay the effective date of LIFO recapture for 1 year for the following reasons.

It discriminates only against corporations. It legitimizes double taxation. It taxes inflation, not real inventory value. It singles out only LIFO users. It violates section 337 of the Code. It discourages the use of LIFO inventory accounting by taking away its benefit.

The recapture provision severely impedes the ability of a family owned, closely held business to dispose of its assets other than through merger or acquisition. Furthermore, section 403(b) financially restricts that company from finding a buyer as the recapture liability would impact negatively on a company's balance sheet. Thus, a company's LIFO reserve would become a liability when liquidated, and a company would not get its actual full value.

If I may say one other thing, Mr. Chairman. I previously spent over 3 years as the tax economist for the Senate Small Business Committee, and during that time I traveled nearly one-half million

miles a year speaking to small businesses. And the one certainty in all of this is the fact that small businesses are so preoccupied with trying to stay in business that they haven't got the time nor the resources to worry about what would happen if they are forced into a liquidation—contrary to what Treasury has said.

Therefore, Mr. Chairman, NAWGA urges this committee to support a deferral of section 403(b) of the Windfall Profits Act of 1980.

Thank you.

Mr. GIBBONS. Thank you.

[The prepared statement follows.]

STATEMENT OF DENIS R. ZEGAR, DIRECTOR, GOVERNMENT SERVICES, NATIONAL-AMERICAN WHOLESALE GROCERS' ASSOCIATION

Mr. Chairman, on behalf of the National-American Wholesale Grocers' Association (NAWGA), it is a pleasure to appear before you today to express the views of NAWGA on this important issue of LIFO Recapture.

NAWGA is a national trade association representing nearly 400 independent grocers and foodservice distributors. These companies, both large and small, supply nearly $50 billion of the Nation's wholesale grocery product volume and account for roughly one-third of the Nation's grocery supply distributed through nearly 800 distribution centers nationwide. NAWGA's foodservice division, the International Foodservice Distributors Association (IFDA), represents nearly 250 member firms who sell annually nearly $10 billion in food and related products to the institutional, away from home foodservice market.

LIFO RECAPTURE

Section 403(b) of the Crude Oil Windfall Profits Act of 1980 requires those on LIFO to treat the LIFO reserve as ordinary income upon the liquidation of a corporation. A principle method by which any business may be transferred is through the sale of its assets. A business wanting to sell its entire inventory may presently choose to liquidate under Section 337 of the code. Currently, under Section 337, no tax consideration is given to a corporation that must liquidate its entire inventory. Furthermore, liquidation under Section 337 explicitly protects the shareholder and corporation from double taxation (taxation on both the gain to the corporation on sale of assets and the gain to the shareholder upon liquidation). The proceeds of the sale of assets are distributed to only the stockholder or stockholders.

If the recapture provision of Section 403(b) is allowed to take effect, corporations liquidating under Section 337 who are, also, on LIFO, will have their LIFO reserve taxed (difference between FIFO and LIFO at ordinary rates). In other words, Section 403(b) will reverse the long standing tax benefit rule of not taxing shareholders and the corporation (double taxation). Tantamount in importance is that the LIFO recapture provision discriminates not only among the form of business, but, also, the type of inventory accounting practice as well. At this time, NAWGA strongly urges the Committee to delay the effective date of LIFO recapture for one year for the following reasons:

1. It discriminates against only corporations
2. It legitimizes double taxation
3. It taxes inflation not real inventory value
4. It singles out only LIFO users
5. It violates section 337 of the code
6. It discourages the use of LIFO inventory accounting by taking away its benefit.

The recapture provision also severely impedes the ability of a family owned, closely held business to dispose of its assets other than through merger or acquisition. Furthermore, Section 403(b) financially restricts a company from finding a buyer as the recapture liability would impact negatively on a company's balance sheet. Thus, a company's LIFO reserve would become a liability when liquidating and a company would not get its actual full value.

Once again, Mr. Chairman, NAWGA urges this Committee to support a deferral of Section 403(b) of the Crude Oil Windfall Profits Act of 1980.

Thank you for the opportunity to appear before you today.

Mr. GIBBONS. Thank you.

Mr. Fitch.

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT FOR GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. FITCH. Mr. Chairman, I do not think I can add any more to what Denis has said, nor can I add anything more to what the previous witnesses said. Suffice it to say that NAW supports the deferral. Ultimately we want to see the provision repealed. And I just want you to know that our 120 associations and 50,000 individual wholesaler-distributors strongly support what this committee is doing, and we commend the committee and its staff for the excellent bipartisan work it has done on this issue.

Thank you.

Mr. GIBBONS. We might extend it for a year and then repeal at the end of the year.

Mr. FITCH. Absolutely.

[The prepared statement follows:]

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

Before I get into the substance of my statement, I would like to express my sincere appreciation to you, Mr. Chairman, the members of this Committee, and especially the staff, for your sensitivity to this highly technical and controversial issue. There is no question that the 45,000 wholesaler-distributor members of NAW's 120 member national assoications appreciate this effort and will be duly apprised once the one-year delay of Section 403(b) of Public Law 96-223 has been enacted.

NAW is a federation of 120 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributions, with 150,000 places of business (see attached list).

The members of our constitutent associations are responsible for 60 percent of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

THE INDUSTRY

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99 percent had assets of $10 million or less. These smaller firms accounted for about 58 percent of the industry's sales volume. In constrast, in the manufacturing sector, approximately 2 percent fo the firms controlled about 88 percent of the assets and accounted for approximately 80 percent of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15 percent above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

A 1980 profile of the wholesale trade, as compiled by the U.S. Department of Commerce from Census Bureau figures, shows the following:

SIC codes: 50-51

Sales (million dollars)	955,175
Employment (000)	5,280
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million dollar)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Futher, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products.

The majority of customers are small businessmen, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

In May, 1980, President Carter signed into law Public Law 96-223, the Crude Oil Windfall Profits Tax Act, which included a provision Section 403(b) that would recognize the gain on LIFO reserves upon liquidation.

This provision, as explained below, is a highly technical, complex and controversial issue that was included in the Senate version of Public Law 96-223 at the request of the Treasury Department without public hearings or input of any kind.

At the strong insistence of the House conferees, the effective date of the provision was postponed for two years (until December 31, 1981) to allow time for Congressional hearings.

To date, no hearings have been held in either the House or the Senate on the merits of 403(b); with less than a month until anticipated adjournment, delay of the provision for another year is the only responsible course of action left.

H.R. 4717, introduced by Congressman Ed Jenkins, and H.R. 5011, introduced by Congressman Bill Gradison, accomplish this objective.

To prepare the detailed and complex testimony that would be required for hearings on the merits of the LIFO recapture issue at this late date would violate equity and would place unnecessary and unreasonable burdens on the parties most affected by the provision. Thus, a one-year delay of 403(b), until hearings on the merits of the issue can be held next year, is imperative.

NAW's position is based on three primary considerations:

Election of President Reagan in November, 1980, and the subsequent appointment of new Treasury Department policy officials who have not had the time or opportunity to adequately review this issue;

Enactment of the Economic Recovery Tax Act of 1981, which mandates that Treasury study the entire inventory issue and report its findings and recommendations to Ways and Means by December 31, 1982. 403(b) is an inventory issue that has significant financial impact on small closely held businesses such as wholesale distribution firms. Its delay, which would coincide with the inventory study, is not only logical, but ultimately good tax policy.

The highly irregular method by which the provision was included in the Windfall Profits Tax Act, given its highly controversial nature and significant financial and tax ramifications, violated equity and the purpose of public hearings and input. In effect, it arbitrarily denied Congress its prerogative of reviewing the pros and cons of an issue and making an informed and knowledgeable decision on the merits.

While this forum is not designed to address the merits of the issue, suffice it to say that NAW strongly supports ultimate repeal of the provision and would hope to persuade this Committee to that viewpoint at subsequent hearings next year.

On behalf of the small, family-owned, closely-held wholesale distrribution firms, NAW strongly urges this Committee to favorably report a one-year delay of section 403(b) of Public Law 96-223 and have it immediately considered by the House.

The wholesaler-distributors in your Districts would greatly appreciate this effort.

This concludes my statement. I would be glad to answer any questions.

TECHNICAL EXPLANATION OF CURRENT LAW VIS-A-VIS SECTION 403(b) OF PUBLIC LAW 96-233

Under present law, a liquidating corporation will not recognize any gain or loss on the transfer of its inventory to its shareholders as part of the liquidation. Similarly, a corporation which sells its assets during a 12-month liquidation (seciton 337) will not recognize any gain or loss on the bulk sale of its inventory. In either situation, if the liquidating corporation accounts for its inventory on the last-in, first-out ("LIFO") method of accounting for inventories, any gain attributable to the excess (referred to as the "LIFO recapture amount") of the adjusted basis of the inventory under the first-in, first-out ("FIFO") method of accounting for inventories over its LIFO adjusted will not be subject to corporate tax. [This amount is presently taxed at the corporate level on a non-liquidating distribution (sec. 311(b)).]

Under Section 403(b), a corporation which distributes its LIFO inventory in a partial or complete liquidation must recognize the inventory's LIFO recapture amounts as ordinary income. Also, a corporation that sells its LIFO inventory in the course of a 12-month liquidation (section 337) must recognize the inventory's LIFO recapture amount as ordinary income.

The tremendous impact of 403(b) on wholesaler-distributors who characteristically liquidate by asset sale and whose major asset is their inventory is dramatically apparent. The fact that 99 percent of all wholesale-distribution are closely-held and family-owned exacerbates the situation.

NATIONAL WHOLESALER-DISTRIBUTOR ORGANIZATIONS AFFILIATED WITH THE NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Air-conditioning & Refrigeration Wholesalers.
American Dental Trade Association.
American Jewelry Distributors Association.
American Machine Tool Distributors' Association.
American Supply Association.
American Surgical Trade Association.
American Traffic Services Association.
American Veterinary Distributors Association.
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors.
Association of Footwear Distributors.
Association of Steel Distributors.
Automotive Service Industry Association.
Aviation Distributors & Manufacturers Association.
Bearing Specialists Association.
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association.
Ceramic Tile Distributors Association.
Ceramics Distributors of America.
Cooperative Food Distributors of America.
Copper & Brass Servicenter Association.
Council for Periodical Distributors Association.
Council of Wholesaler-Distributors, American Institute of Kitchen Dealers.
Distributors Council, Inc.
Door & Hardware Institute.
Drug Wholesalers Association.
Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.
Farm Equipment Wholesalers Association.
Flat Glass Marketing Association.
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association.
Foodservice Equipment Distributors Association.
Foodwervice Organization of Distributors.
General Merchandise Distributors Council.
Hobby Industry Association.
International Ceramic Association.
The Irrigation Association.
Institutional & Service Textile Distributors Association, Inc.
Laundry & Cleaners Allied Trades Association.

Machinery Dealers National Association.
Mass Merchandising Distributors Association.
Material Handling Equipment Distribution Association.
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council.
Music Distributors Association.
National-American Wholesale Grocers' Association.
National Appliance Parts Suppliers Association.
National Association of Aluminum Distributors.
National Association of Brick Distributors.
National Association of Chemical Distributors.
National Association of Container Distributors.
National Association of Container Distributors.
National Association of Decorative Fabric Distributors.
National Association of Electrical Distributors.
National Association of Fire Equipment Distributors.
National Association of Flor Covering Distributors.
National Association of Manufacturing Opticians.
National Association of Marine Services, Inc.
National Association of Meat Purveyors.
National Association of Plastics Distributors.
National Association of Rocording Merchandisers, Inc.
National Association of Service Merchandising, Inc.
National Association of Sporting Goods Wholesalers.
National Association of Textile & Apparel Distributors.
National Beer Wholesalers Association.
National Building Material Distributors Association.
National Business Forms Association.
National Candy Wholesalers Association.
National Commercial Refrigeration Sales Association.
National Electronic Distributors Association.
National Fastener Distributors Association.
National Food Distributors Association.
National Frozen Food Association.
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association.
National Industrial Glove Distributors Association.
National Lawn & Garden Distributors Association.
National Locksmiths' Suppliers Association.
National Marine Distributors Association.
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association.
National Sash & Door Jobbers Association.
National School Supply & Equipment Association.
National & Southern Industrial Distributors Association.
National Spa and Pool Institute.
National Truck Equipment Association.
National Welding Supply Association.
National Wheel & Rim Association.
National Wholesale Druggists' Association.
National Wholesale Furniture Association.
National Wholesale Hardware Association.
Northamerican Heating & Airconditioning Wholesalers.
North American Wholesale Lumber Association, Inc.
Optical Laboratories Association.
Pet Industry Distributors Association.
Petroleum Equipment Institute.
Power Transmission Distributors Association. Inc.
Safety Equipment Distributors Association, Inc.
Scaffold Industry Association.
Shoe Service Institute of America.
Specialty Tools & Fasteners Distributors Association.
Steel Service Center Institute.
Toy Wholesalers' Association of America.
United Pesticide Formulators & Distributors Association.
Wallcovering Distributors Association.
Warehouse Distributors Association for Leisure & Mobile Products.

Watch Materials & Jewelry Distributors Association.
Water and Sewer Distributors Association.
Wholesale Florists & Florist Suppliers of America.
Wholesale Stationers' Association.Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance.
Woodworking Machinery Distributors Association.

Mr. GIBBONS. Mr. Goldberg.

STATEMENT OF JAMES M. GOLDBERG, COUNSEL, NATIONAL SHOE RETAILERS ASSOCIATION; NATIONAL LUMBER & BUILDING MATERIAL DEALERS ASSOCIATION; NATIONAL ASSOCIATION OF RETAIL DEALERS OF AMERICA

Mr. GOLDBERG. Thank you, Mr. Chairman.

On behalf of the small business trade association clients which we represent, we would also support a deferral. Like John, what we are ultimately looking for is a repeal of the provision. And the reason is—and this is part of the reason for supporting a deferral at this time—that the small business community is getting conflicting signals from the Congress as to what the congressional intent is vis-a-vis LIFO.

On the one hand, you have this year's Economic Recovery Tax Act which talks in terms of directing the Treasury to issue regulations making LIFO more widely available by index borrowing and other means. And on the other hand we have a provision in the Windfall Profit Tax Act which says we are going to take away all those gains which you make by using LIFO.

For those reasons we would urge that the deferral bill be passed now, and when you do get around to hearings on the merits of the subject, rest assured that we will be there urging that it be repealed.

[The prepared statement follows:]

STATEMENT OF JAMES M. GOLDBERG, WASHINGTON, D.C.

My name is James M. Goldberg. I am an attorney in private practice in the District of Columbia. Our firm represents several trade associations whose members are owners and operators of small businesses. These businesses, mostly family-run and virtually all privately held, are very concerned about soon-to-become-effective provisions of the Crude Oil Windfall Profits Tax Act requiring firms using the last-in first-out inventory accounting method to repay taxes they save using LIFO when liquidating their business inventory.

I appreciate the opportunity to testify before the Committee on H.R. 4717 and H.R. 5011, bills to amend the effective date provision of Section 403(b)(3) of the Windfall Profits Tax Act of 1980, and urge their speedy adoption.

What is at stake here is significant tax policy, affecting thousands of small businesses across the country. However, Section 403(b)(3) was added to the Windfall Profits Tax Act by the Senate Finance Committee without the benefit of public hearings and was accepted by this committee also without prior hearings.

The section seems to be based on an assumption that the LIFO method isnot an acceptable method of inventory accounting. On the contrary, however, the acceptability of the LIFO method has long been recognized by the IRS and was given further support by provisions of the Economic Recovery Tax Act to encourage the use of LIFO by small businesses.

The Economic Recovery Tax Act also directs the Treasury Department to study the merits of the LIFO accounting method and report back to Congress by December 31, 1982. In light of Congressional intent to study the issue, a delay in the effective date of the LIFO recapture provision until the Treasury Department study is completed is in order. A delay in the effective date of this controversial provision would also give the small business community the opportunity to comment on use of the LIFO inventory accounting method and on the potential effects of a LIFO recapture requirement from the perspective of small business owners.

We therefore strongly support H.R. 4717 and H.R. 5011 to delay the effective date of the LIFO recapture provision and urge that prompt action be taken to move these bills to the House floor.

Mr. GIBBONS. Mr. Grossman.

STATEMENT OF JEROME K. GROSSMAN, MURDOCH & WALSH, P.A., WILMINGTON, DEL.

Mr. GROSSMAN. Thank you, Mr. Chairman.

I am Jerome Grossman. I am a shareholder and director in the law firm of Murdoch & Walsh in Wilmington, Del.

I have been involved with this LIFO recapture issue in the American Bar Association for the last year. I agree with the previous speakers that ultimately what this committee should recommend is repeal of this provision, but certainly I support a deferral of the effective date at this time.

I would just like to make a couple of points in response to some of the points raised by Mr. Chapoton.

First, in the colloquy with respect to whether or not this actually constitutes a tax on inflation, Mr. Chapoton indicated that if that was the case each company's inflation rate would correspond to the consumer price index increase. That is simply not the case.

Each company has its own internal rate of inflation, and as the various members of the committee have indicated, this provision really is simply a tax on inflation-induced increases in inventory value. That is No. 1.

Number two, he indicated that the LIFO recapture provision was consistent with the various tax provisions currently in the code. That is not the case. He mentioned section 311(b), which takes nonliquidating distributions of appreciated inventory. When that was enacted in 1954 Congress specifically was asked whether to apply that type of provision to distributions in liquidation. It was determined that there should be no analogous provision in section 336 or 337 because there just was not the same opportunity for abuse. And that, to my knowledge, has not changed since the 1954 code was adopted. As far as I am concerned, this LIFO recapture provision is antithetical to present tax policies, not in consonance therewith.

I thank the committee for allowing me to present my views.

[The prepared statement follows:]

STATEMENT OF JEROME K. GROSSMAN, ESQ., WILMINGTON, DEL.

This statement is submitted in connection with the Committee's consideration of H. R. 4717 and H. R. 5011 (sometimes hereinafter referred to as the "bills"), both having to do with deferring, from January 1, 1982 until January 1, 1983, the effective date of the so-called "LIFO recapture" provisions set forth in section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980 (P.L. 96-223) (sometimes hereinafter referred to as the "Act").

I am an attorney in private practice in Wilmington, Delaware. Most of the clients of our firm are principals in small businesses, the predominant portion of which are closely held.

I am a member of the Inventories Subcommittee of the Tax Accounting Problems Committee of the American Bar Association and was involved to a substantial extent in the development of a policy for that committee with respect to the "LIFO recapture" provisions. I am also the Chairman of the Tax Committee of the Delaware Society of Certified Public Accountants and I have written an article entitled "Liquidations of LIFO Inventories After the Crude Oil Windfall Profit Tax Act of 1980" which was published at 58 TAXES 664 (September, 1980).

Summary of Statement

I urge the Committee to recommend the repeal of Act Sec. 403(b), or, at the very least, the enactment of the bills deferring the effective date of Act Sec. 403(b) until January 1, 1983.

The reasons why Act Sec. 403(b) should either be repealed, or the very least, the effective date thereof be deferred, are because the so-called "LIFO recapture" provisions set forth therein:

1. Discriminate against taxpayers using the LIFO method of accounting for inventory;

2. Almost exclusively adversely impact upon closely-held businesses, the vast majority of which are small businesses;

3. Constitute a tax on inflation;

4. Establish a new principle of taxation without the benefit of Congressional hearings and seek to apply that new principle retroactively;

5. Create numerous technical difficulties in tax administration; and

6. Create relatively small amounts of additional revenues.

Background

Section* 472 authorizes the use, for federal income tax purposes, of the LIFO method. The utilization of the LIFO method

*Unless otherwise indicated, all "section" references are to sections of the Internal Revenue Code of 1954, as amended.

has increased substantially in the last several years due to its efficacy during inflationary periods. LIFO is an inventory pricing technique entailing an assumption as to the flow of costs. Unless current inventory costs decrease or there is a decrease in inventory volume, the utilization of the LIFO method will eliminate the higher replacement costs associated with inflation from the inventory value, thereby increasing the cost of goods sold and decreasing income. The utilization of the LIFO method is, additionally, in consonance with generally accepted principles of accounting. The American Institute of Certified Public Accountants has stated as follows:

> ....LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices. APB Statement No. 4, §172 (1970).

Section 337 was enacted to permit a corporation which sells assets during the twelve-month period following the adoption of a plan of complete liquidation and which distributes its assets in complete liquidation to, generally, avoid taxation on any gain resulting from such sales. In Rev. Rul. 74-431, 1974-2 C.B. 107, the issue was whether the tax benefit rule was applicable to a bulk sale of inventory where the cost of the inventory on the books of the selling corporation under the LIFO method was substantially less than the fair market value of the

inventory at the time of sale. The Internal Revenue Service (the "Service"), while noting that the tax benefit rule was applicable to section 337 liquidations, held that the rule was not applicable to inventories costed under the LIFO method. The Service distinguished Bishop v. U.S., 324 F. Supp. 1105 (M.D. Ga. 1971) by stating that whereas the deductions from ending inventory under the farm-price method have the "same economic effect as deductions . . . under section 162," the LIFO method is merely "a technique for sequencing the flow of costs through inventory" and it "does not create a deduction that can be recovered." Rev. Rul. 74-431, 1974-2 C.B. 107, 108.

Section 334(b)(2) provides that the parent corporation's basis for property acquired in the complete liquidation of an 80%-owned subsidiary under section 332 is the parent's adjusted basis in the subsidiary's stock. Since section 334(b)(2) applies only when the eighty percent control is acquired by purchase during a 12-month period from unrelated parties, the thrust of section 334(b)(2) is to treat the transaction as a purchase, by the parent, of the underlying assets of the subsidiary. Presumably, the selling price of the stock will reflect the fair market value or the underlying assets. As such, the differential between the cost of the inventory under the LIFO method and the fair market value of the inventory will be included in the income of the seller at the time of the sale, but is taxed at capital gains rates. The tax treatment of the actual liquidation is governed by section 336, the enactment of which in 1954 was

designed to provide simple, consistent tax treatment of liquidations and to reduce the level of taxation in liquidations. In a fairly recent Technical Advice Memorandum (Letter Rul. 8019118), the issue was whether the tax benefit rule was applicable to the distribution of a corporation's inventory costed on a LIFO basis in a transaction governed by section 334(b)(2). The Service, relying on the rationale of Rev. Rul. 74-431, held that the transaction did not result in the recovery of a previously deducted amount under the tax benefit rule.

Thus, with respect to both section 334(b)(2) and section 337 liquidations, the law as it existed prior to the enactment of Act Sec. 403(b) provided that the differential between LIFO and FIFO cost would not be taxed as ordinary income. The tax benefit doctrine, as codified in section 111, was construed to apply to losses and deductions. As previously noted, the Service, in Rev. Rul. 74-431, held that the LIFO method of costing inventory does not create a deduction but is merely a technique for sequencing costs, although it did express doubts about the correctness of the holding of Rev. Rul. 74-431 in Letter Rul. 8019118.

Section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980

Act Sec. 403(b) was introduced by Senator Ted Stevens (R-Alaska) as Amendment No. 592 to the Windfall Profit Tax Act. No hearings were held with respect to the amendment, which was approved by the Senate and later agreed to by the House. The only modification to the amendment was that its effective date was delayed so as to make its provisions applicable to

distributions and dispositions pursuant to plans of liquidation adopted after December 31, 1981.

Effective with respect to distributions and dispositions pursuant to plans of liquidation adopted after December 31, 1981, section 336 now provides that if a corporation inventorying goods under the LIFO method distributes inventory assets in partial or complete liquidation, then the "LIFO recapture amount" will be treated as gain to the corporation recognized from the sale of such inventory assets, thereby being taxed as ordinary income. This treatment is an exception to the general rule of nonrecognition of gain or loss in corporate liquidations set forth in section 336 and is not applicable to any liquidation under section 332 for which the basis of the property received is determined under section 334(b)(1) (carryover basis). Furthermore, effective with respect to distributions and dispositions pursuant to plans of liquidation adopted after December 31, 1981, section 337 now provides that if a corporation inventorying goods under the LIFO method sells such inventory assets in a "bulk sale" as defined in section 337(b)(2) and such sale is within the 12-month period beginning on the date on which a corporation adopts a plan of liquidation and during which all of the assets of the corporation are distributed is complete liquidation, then the gain, if any, from such sale is recognized by the corporation to the extent of the "LIFO recapture amount".

Discriminatory Impact of "LIFO Recapture" Provisions

The new rules of Act Sec. 403(b) arbitrarily discriminate against taxpayers using the LIFO method, irrespective of the fact that the LIFO method is expressly authorized by section 472 and even though it is in consonance with generally accepted accounting principles. The sparse legislative history indicates that the Congressional intent was to provide for consistent treatment among similarly situated taxpayers, but the effect of the new rules is to actually exacerbate disparate treatment by discriminating against taxpayers using the LIFO method. The cost of inventories computed using the lower of FIFO cost or market method authorized by Reg. §1.471-2 and Reg. §1.471-4 may be less than cost of inventories computed using the LIFO method. Yet, the new rules single out for taxation only the "LIFO recapture amount," defined in section 336(b)(3) as "the amount (if any) by which ... the inventory amount of the inventory assets under the first-in, first-out method... exceeds... the inventory amount of such assets under the LIFO method." It should be noted that the statutory language, by not referring to the lower of FIFO cost or market method, does not even permit a taxpayer to avail itself of the same market write-downs available to taxpayers using the FIFO method. This is to be contrasted with Section 311(b), which permits the use of the lower cost or market method.

To illustrate the disparate treatment caused by the new

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provisions, consider the following two situations. In Situation 1, Corporation A, a January 31 fiscal year taxpayer, uses the LIFO inventory method. At the end of its first fiscal year, January 31, 1981, it has an inventory of 10,000 widgets with a per unit LIFO cost of $10 for a total inventory of $100,000. During the next fiscal year, A purchases 10,000 widgets at a unit cost of $40 and sells 10,000 widgets as well. Under the LIFO method, its inventory cost at January 31, 1982 is still $100,000, the $300,000 paid for the widgets being charged to cost of goods sold. Corporation A then adopts of plan of complete liquidation under section 337 on February 1, 1982 and sells its inventory in bulk to an unrelated purchaser, Corporation B, on February 28, 1982 for $500,000, its then fair market value. On this date, the LIFO inventory amount was $100,000 and the hypothetical FIFO inventory amount was $400,000. Assume further that Corporation B sells the acquired inventory for $500,000 in the ordinary course of business. Under the new provision, Corporation A must recognize $300,000 of ordinary gain attributable to the LIFO recapture amount [$400,000 (FIFO amount) minus $100,000 (LIFO amount)]. Corporation B recognizes no gain since it has a cost basis for the acquired inventory of $500,000. The gain attributable to the excess of the selling price of the inventory over its hypothetical FIFO cost ($500,000 - $400,000 = $100,000) is not recognized at the corporate level.

In Situation 2, the facts are identical to the facts in Situation 1 except that Corporation A uses the specific identification method. Under that method, it is determined that

the 10,000 widgets sold to Corporation B on February 28, 1982 are the same widgets purchased in the corporation's initial fiscal year at a $10 unit cost. In other words, the actual flow of inventory under the specific identification method was identical the assumed flow under the LIFO method. However, since the new rules apply only to LIFO taxpayers, Corporation A recognizes no gain on the sale of the widgets to Corporation B for $500,000 and Corporation B has a cost basis for the acquired inventory of $500,000.

The disparate results in the foregoing examples cannot be justified as rational tax policy. The discrimination against taxpayers using the LIFO method is even more egregious when the treatment of LIFO method taxpayers is compared to the treatment of farmers not required to compute taxable income on the accrual method of accounting under section 447. Farmers using the cash receipts and disbursements method of accounting are permitted to deduct, as current expenses, the costs of goods which would otherwise be characterized as inventory. However, even though some of those goods may be on hand when a farming corporation is liquidated, because such goods are not inventories costed under the LIFO method, the new statutory provisions described hereinabove would not be applicable and no gain would be recognized at the corporate level.

The arbitrariness of the discrimination against taxpayers using the LIFO method is further demonstrated by the failure of a the new provisions to allow a deduction to a

taxpayer using the LIFO method when the hypothetical FIFO cost of the inventory falls below its LIFO cost, such as when market values decline or when there have been substantial write-downs of normal or subnormal goods. For example, assume that Corporation C, a calendar year taxpayer, uses the LIFO inventory method. At the end of its first taxable year, December 31, 1980, it has an inventory of 10,000 widgets with a per unit LIFO cost of $10 for a total inventory of $100,000. The market price of widgets declines in 1981 during which period C purchases 10,000 widgets at a unit cost of $8 and sells 10,000 widgets as well. Under the LIFO method, its inventory cost at December 31, 1981 would be $100,000 and the $80,000 paid for widgets in 1981 would be charged to cost of goods sold. Corporation C then adopts a plan of complete liquidation under section 337 on January 1, 1982 and sells its inventory in bulk to an unrelated purchaser, Corporation D, on January 15, 1982 for $80,000, its then fair market value. On this date, the LIFO inventory amount would be $100,000 and the hypothetical FIFO inventory amount would be $80,000. The $20,000 loss attributable to the excess of the LIFO cost of the inventory over its selling price is not recognized at the corporate level. If, on the other hand, Corporation C had utilized the lower of FIFO cost or market inventory method, its cost of goods sold deduction in 1981 would have been $100,000, not $80,000. This type of discrimination is not in consonance with a rational tax policy.

In addition to the aforementioned discrimination, the provisions discriminate against corporations as opposed to partnerships and proprietorships since the rules are set forth only in sections 336 and 337.

Adverse Impact Upon Small Businesses

The new rules codified in sections 336 and 337, although prima facie neutral, also discriminate against closely-held businesses, which are most often small business as well. Large, publicly-held companies rarely liquidate. The sale of the assets of a publicly-held company more often takes the form of a tax-free reorganization under section 368, a section not reached by the new rules. Conversely, however, small businesses often are forced to liquidate when key personnel die or become disabled and the heirs are unwilling or unable to continue to operate the business. It is this forced liquidation situation which will be reached, most often, by the new rules.

This discrimination against small businesses is exacerbated by the complexity of the new provisions. As will be illustrated hereinafter, there are some major unresolved technical problems with the new provisions. Furthermore, the new provisions may require taxpayers using the LIFO method to keep two sets of books, a cost many small businesses cannot afford. Additionally, many small businesses may not even be aware of the new provisions. Yet the new provisions are retroactive in effect since they tax the "LIFO reserve" from all prior years, maybe

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even back to 1938. On the other hand, large businesses and their advisors can mitigate the harshness of the rules by planning.

The disproportionate impact upon small businesses is ironic given the expressed desire of Congress to make the LIFO method more readily available to small businesses, as evidenced by the recent enactment of Sections 237 and 238 of the Economic Recovery Tax Act of 1981 (P. L. 97-34). In its report entitled "Inventory Accounting as a Burden on the Capital Formation Process," the House Committee on Small Business, in the "Findings" section of the report, noted as follows:

> E. The subcommittee finds that the last-in, first-out (LIFO) method is generally the preferred method of accounting for inventories, as it lessens taxable income in periods of high rates of inflation. However, small business does not use it because of its complexity. (Emphasis added). H. R. REP. NO. 96-1448, 96th Cong., 2d Sess. (1980).

The new rules will have an in terrorem effect on many small businesses, their discriminatory impact causing these small businesses to refrain from adopting the "preferred" LIFO method of accounting for inventories. The new rules will also have the effect of encouraging small businesses to merge into large corporations with a concomitant adverse impact upon competition.

Tax on Inflation

The double taxation of the "LIFO recapture" amount is particularly offensive since it is clearly taxing inflationary gain rather than real economic gain.

By treating the "LIFO recapture amount" as one of the very few exceptions to the general nonrecognition rules of sections 336 and 337, Congress has erroneously characterized the utilization of the LIFO method as being analogous to the claiming of depreciation deductions. Corporations which are going concerns usually have assembled a core of assets consisting of, inter alia, buildings, equipment, land and inventory. When such assets of a liquidating corporation are acquired by another going concern corporation, some portion of the cost of the buildings and equipment will have been claimed as tax deductions even though the market value of the assets may have increased. To the extent that the market value or selling price of such assets exceeds their tax bases, it may be appropriate for prior depreciation to be recaptured as ordinary income to offset prior depreciation deductions from ordinary income. However, no portion of the cost of land and no portion of the LIFO inventory on hand will have been claimed as a tax deduction regardless of their respective current market values. If the effect of inflation were removed from the market value of the land and LIFO inventory, then there probably would be very little difference, if any, between the market value and cost of each.

Inventory is more akin to the land in the foregoing example than to the depreciable property. Unlike depreciation, the use of the LIFO method, as recognized by the Service in Rev. Rul. 74-431, does not create deductions, it is merely an assumption as to the flow of costs through inventory. As noted

hereinabove, the LIFO method, which is in consonance with generally accepted accounting principles, is used to determine inventory cost and to match such costs against revenue in computing income, and does not create deductions. Furthermore, any "benefit" derived from the utilization of the LIFO method in an inflationary economy relates to assets disposed of prior to liquidation, whereas the depreciation deductions relate to assets still in existence at the time of liquidation. Moreover, when all of the assets of a liquidating corporation are acquired, the acquiring corporation ordinarily will maintain or expand its base inventory. If the acquiring corporation uses the LIFO method, the tax benefit from stepping up the basis of the base inventory will not be realized until its operations are reduced and all or part of the acquired base inventory is liquidated. In the interim, the base inventory has no tax significance and can be viewed as a non-depreciable fixed cost, similar to land.

Establishment of New Taxation Principle Without Congressional Hearings

In providing for the double taxation of inflation-induced inventory gain, Congress has established a new principle of taxation without having had the benefit of Congressional hearings. Act Sec. 403(b), introduced by Senator Ted Stevens (R - Alaska) as Amendment No. 592 to the Windfall Profits Tax Act, was the second part of an amendment which provided, basically, that there would be no recapture of the "LIFO reserve" of oil companies attributable to inventory

liquidations caused by government regulations or foreign trade interruptions where the liquidated inventories were replaced within three years. Bureau of National Affairs, 11 Daily Tax Report G-5 (January 16, 1980) reported that the Treasury Department "agreed not to oppose" this part of the amendment if Senator Stevens agreed to introduce the provision which eventually was enacted as Act Sec. 403(b). Although the germaneness of the first part of Senator Stevens' amendment can be demonstrated, the relationship between the second part of the amendment and the Windfall Profits Tax Act is tenuous. In any event, establishing a new principal of taxation without the benefit of any Congressional hearings is not the proper method for effectuating tax policy. It should be noted that the issue of taxing inventory profits in corporate liquidations was the subject of extensive Congressional hearings in 1954 during the adoption of the Code and Congress ultimately decided to delete this concept from the Code.

Creation of Technical Difficulties and "Unsimplification"

As a result of the absence of Congresional hearings, the new rules are fraught with substantial unresolved technical difficulties. The computation of the "LIFO recapture amount" requires the taxpayer to calculate a hypothetical FIFO value of the inventory. Since the taxpayer has not been using the FIFO method, it will be required to compute a full absorption FIFO cost for the inventory, a computation which will not be possible for many taxpayers since such taxpayers will not have the

requisite data. Additionally, although the statute apparently does not permit a taxpayer to reduce FIFO cost for write-downs of normal goods to market value or for write-downs of subnormal or obsolete goods, if such reductions are administratively approved, then computations for a series of years will be required. The practical effect of these new rules is that all taxpayers using the LIFO method who contemplate that the corporation may, at some time in the future, be liquidated, will now be required to keep two sets of books, one using the LIFO method and one using the FIFO method. Furthermore, obtaining FIFO cost data will simply not be possible in some industries. It is clear that the short-circuiting of the legislative process caused the passage of rules containing serious technical deficiencies.

As illustrated by the discussion of some of the technical deficiencies of the new rules hereinabove, the new rules have injected additional complexities into the Code. The provisions constitute another trap for the unwary at a time when Congress has expressed a desire for tax simplification. Corporations which are aware of the provisions can mitigate their harshness. A corporation selling its inventory in bulk in a section 337 transaction would want the agreement to allocate an amount to inventory equal to the LIFO cost, with the excess value allocated to other assets not subject to recapture. As indicated heretofore, many corporations will simply utilize tax-free reorganizations involving big businesses. Since there are no

countervailing tax policy considerations supporting the new rules, the additional complexity engendered thereby cannot be justified.

The new provisions will inpact on few, if any, abusive transactions. The differences between the utilization of the LIFO method and the claiming of depreciation deductions illustrate this point as well. Section 1245 was enacted to close a putative loophole which permitted taxpayers to claim depreciation deductions which offset ordinary income and turn around and sell the depreciated property at capital gains rates. The same tax avoidance potential is not present in the case of corporate liquidations and LIFO inventories. A corporation does not acquire inventory with the intention of selling it at capital gains rates after it has appreciated. If it held the inventory for appreciation, it might not even properly be characterized as inventory. Furthermore, a corporation normally does not liquidate simply to have its appreciated inventory taxed at capital gains rates. First, its shareholders would normally be taxed upon liquidation. Second, if it were availed of for this tax avoidance purpose, the collapsible corporation provisions of section 341 would probably be applicable. Moreover, if the acquiring corporation expands the acquired business and continues the LIFO method, there will probably be incremental layers and, in the case of many going concerns, this means that any tax benefit will be deferred indefinitely. Again, Congress considered the concept of taxing inventory profits in corporate

liquidations extensively in 1954 and found that section 341 was sufficient to handle any abusive situations. There is nothing to indicate that experience since 1954 would argue for a contrary conclusion.

No Significant Revenue Enhancement

The absence of a serious tax avoidance problem is illustrated by the small amount of additional revenues estimated to be received because of these new rules. The estimated revenue gain is only $250,000,000 annually. H. R. REP. NO. 96-817, 96th Cong., 2d Sess. Table 2. Notwithstanding the minor projected revenue gain set forth hereinabove, the provision could actually cause a reduction in revenues since the provision will cause taxable acquisitions to be restructured in order to avoid recoginition of the "LIFO recapture amount", thereby resulting in lower gains being reported and recognized by the selling stockholders in section 337 transactions, or, alternatively, will lead to restructuring acquisitions as tax-free reorganizations.

For all of the aforementioned reasons, I strongly urge the Committee to recommend the repeal of Act Sec. 403(b), or, alternatively, to favorably report H.R. 4717 and 5011.

Mr. GIBBONS. Questions?

Mr. CONABLE. I have no questions. Thank you. And we appreciate your shortening your testimony.

Mr. GIBBONS. And I have had a chance to review all of your statements. They are very scholarly and very well done, and we appreciate them very much. If you stick around this afternoon, I think you are going to appreciate what happens.

With that, the committee will stand adjourned until 1:30. These hearings are concluded, and the staff has necessary time to make whatever changes, corrections, and additions they want to.

We are adjourned until 2 p.m.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

[The following were submitted for the record:]

AMERICAN BANKERS ASSOCIATION,
Washington, D.C., December 1, 1981.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Ways and Means Committee,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The American Bankers Association, with a membership of more than 90 percent of the country's 14,500 full service banks, is writing in support of H.R. 5013 and to urge its enactment at the earliest possible date.

Commercial banks and bank affiliated mortgage companies represent the second largest source of mortgage orginiations for single-family homes. Traditionally, banks and other depository institutions have relied on individual savings as their main source of funds. But, in recent years, the deposit base for all depository institutions has shifted away from traditional passbook accounts to short-term time deposits, which pay higher rates but are subject to greater interest rate fluctuations.

Because of the enormous capital required for mortgage lending exceeds the liability base of depository institutions, mortgage lenders have developed an active secondary mortgage market as a source of funds. Institutions whose actual deposits have not been keeping pace with the demand for mortgage loans have been able to maintain loan activity by reselling their loans in the secondary market, thus raising the funds for further lending. Operating nationwide, FNMA helps to redistribute mortgage funds from capital-surplus to capital-short areas.

The Federal National Mortgage Association (FNMA) created by Congress in 1968 as a stockholder-owned corporation, operates in the secondary mortgage market as the largest investor in residential mortgage funds, with a portfolio of more than $59 billion of mortgage loans. The 1968 legislation also made FNMA a for-profit, tax paying corporation.

Because FNMA converts funds borrowed in the money and capital markets into residential mortgage loans, its activities and earnings are influenced primarily by the level of interest rates and the availability of alternative sources of mortgage credit. Recent inflation has thrown financial markets and financial intermediaries into disarray. Inflation and gyrating interest rates have generally affected home mortgage financing institutions more than other economic institutions, enforcing on them major institutional changes. FNMA has been forced to borrow in the volatile capital markets of the past year at rates up to 18 percent, increasing FNMA's cost of borrowing to 11.52 percent, while the return on their portfolio was 9.62 percent at September 30, 1981.

FNMA management has responsibly reacted to recent economic conditions by attempting to build greater flexiblity into its asset management by increasing the yield on the corporation's assets and lengthening the term of its debt. However, its asset management has been made difficult because of FNMA's present tax treatment for operating losses.

Our understanding is that FNMA's present loss averaging treatment is unlike the carryback and carryforward treatment provided for other financial institutions. Instead, FNMA can presently carry losses back three years and forward fifteen years. Our Association, Mr. Chairman, supports H.R. 5013 extending FNMA's net operating loss carryback to ten years and reducing its net operating loss carryfor-

ward to five years, thus conforming the tax treatment of FNMA to that of other financial institutions.

Sincerely,

GERALD M. LOWRIE,
Executive Director, Government Relations.

AMERICAN BAR ASSOCIATION,
SECTION OF TAXATION,
Washington, D.C., November 25, 1981.

Re recommended deferral of LIFO recapture provisions.

Hon. DANIEL ROSTENKOWSKI,
House of Representatives,
2111 Rayburn House Office Building,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: The Section of Taxation of the American Bar Association recommends that the Congress take action to defer the effective date of amendments made to sections 336 and 337 of the Internal Revenue Code of 1954 by section 403(b)(1) of the Windfall Profits Tax Act of 1980. These amendments effectively require that a corporate taxpayer utilizing the LIFO method of inventory accounting "recapture" as ordinary income the amount of its LIFO reserve upon liquidation. This provision will, absent legislative action, become effective with respect to plans of liquidation adopted after December 31, 1981.

The Section of Taxation recommends that the effective date of the amendments be deferred for the following reasons:

(1) Although the amendments affect a wide number of taxpayers, they were adopted without benefit of hearings.

(2) It is not immediately clear that a requirement for recapture of LIFO reserves on corporate liquidation represents sound tax policy. There seem to be other similar situations where no recapture is required.

(3) If the amendments ultimately become effective, it is probably sound tax policy to exempt LIFO reserves accumulated prior to the effective date, for much the same reason that accumulated depreciation was exempted from recapture upon enactment of section 1245. As presently structured, the amendments do not provide such an exemption.

(4) If the amendments ultimately become effective, it is probably sound tax policy to limit recapture to the difference between the LIFO basis and the inventory basis that would have resulted from use of the lower of cost or market value (as is presently the rule for distributions under section 311(b)). As presently structured, the amendments require recapture of the difference between the LIFO basis and the basis that would have resulted from the use of LIFO.

These difficult issues of tax policy should be considered and resolved. Treasury has already been directed, in section 238 of the Economic Recovery Tax Act, to study various aspects of the LIFO method of accounting for inventory. The questions relating to recapture on corporate liquidation could be made a part of the same study.

The views expressed above are those of the Section of Taxation of the American Bar Association and should not be construed as representing the position of the Association.

Very truly yours,

JOHN B. JONES, Jr.,
Vice Chairman-Government Relations.

AMERICAN RETAIL FEDERATION,
Washington, D.C., December 9, 1981.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: This letter is submitted by the American Retail Federation in support of legislation to delay the effective date of provisions in the Crude Oil Windfall Profits Tax Act of 1980 relating to recapture of LIFO benefits. A copy of this letter is being sent to each member of the Ways and Means Committee.

The American Retail Federation is an organization composed of 27 retail trade associations, state retail associations from all 50 states and the District of Columiba,

and more than 120 retail corporations. The American Retail Federation members, directly and indirectly, include more than 1.5 million retail companies.

Retail firms in general are much less capital intensive than are our industrial counterparts, and inventory costs comprise a much more substantial portion of the total cost of doing business than is generally the case for manufacturers. In the recent period of high inflation, the LIFO inventory method has been critically important to firms seeking to minimize the impact of inflation on their working capital. Therefore, the LIFO recapture provision of the 1980 Act is of considerable significance to the retail sector, and we strongly urge the Committee to adopt legislation such as H.R. 4717 and H.R. 5011 to delay the effective date of the LIFO recapture provision of section 403(b)(3) of the 1980 Act until December 31, 1982.

The LIFO recapture provision requires that a firm utilizing LIFO repay the so-called tax benefit when its inventory is partially or completely liquidated. Substantively, we view LIFO as an accounting mechanism that affects the sequencing of inventory dollars, rather than as a tax benefit. Therefore, recapture as envisioned is inappropriate. In addition, LIFO recapture is contrary to the thrust of recent tax legislation which seeks to lessen rather than increase tax burdens on the productive sectors of the economy.

At the appropriate time, we would like to participate in a longer discussion of the substantive effects of the LIFO recapture provision of the 1980 Act. At this time, we simply urge that you consider the following points:

1. The recapture provision was only briefly considered and then quickly adopted in the waning hours of the enactment of the 1980 Act; the broad impact of the proposal was not well understood at the time;
2. There has been inadequate discussion of the impact of the proposal during the 1981 consideration of tax proposals;
3. Congressional staffs reportedly find flaws in the provision;
4. The provision now appears to be contrary to the beneficial LIFO simplification initiative begun by the Economic Recovery Tax Act of 1981; and
5. A deatailed Treasury study of LIFO mandated by the 1981 Act will not be completed until later next year.

Therefore, we urge the Committee to act favorable and promptly on the legislation to defer the effective dae.

Sincerely,

LOYD HACKLER, *President*

AMERICAN SAVINGS AND LOAN LEAGUE, INC.,
Washington, D.C. December 9, 1981.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Rayburn House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The American Savings and Loan League, a national trade association composed of 75 savings and loan associations in 25 states and the District of Columbia that are owned or controlled by Blacks, Hispanics, Asian-Americans and members of other minority groups strongly supports and urges prompt action on H.R. 5013, a bill to amend the 1954 Internal Revenue Code to conform the net operating loss carryback and carryforward treatment of the Federal National Mortgages Association (FNMA) to that of other financial institutions. Our members view this legislation as most important for the housing industry and for the financial institutions which serve it.

It is no secret that the financial institutions which lend money to those purchasing homes have been hurt. Even at current high mortgage interest rates, the mortgages they hold provide a return far below the sums needed to refund their debt.

FNMA continues to serve as an important link between the housing and finance industries. Throughout the past three years of rising interest rates and declines in the housing market, FNMA has continued to provide liquidity to the home mortgage market by buying mortgages from primary lending institutions so that these institutions can restructure their portfolios and continue to lend money to homebuyers.

So that FNMA can continue to operate effectively and efficiently, it must be permitted to average its losses and gains for tax purposes in the same manner as banks, savings and loan associations, and other financial institutions, rather than as a manufacturing or retailing company, as is presently the case.

Economic conditions affect FNMA profits and losses and other financial institutions in the same way. It is therefore not only equitable, but important to the stability of the home financing industry to allow FNMA to cope with lengthening periods of high interest rates and inflation in the same way as other financial institutions.

The recovery of the housing industry in 1982 can be helped by the early enactment of this legislation.

Sincerely,

THERESA L. WATSON,
Executive Vice President.

ARTHUR ANDERSEN & CO.,
Washington, D.C., December 8, 1981.

Hon. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee,
Longworth House Office Building,
Washington, D.C.

(Attention: John Salmon.)

DEAR MR. CHAIRMAN: Attached is a memorandum prepared by our Firm concerning the LIFO recapture provisions of the "Crude Oil Windfall Profit Tax Act of 1980". We are submitting this memorandum as background for our support of HR 4717 and HR 5011.

These two bills delay the effective date of the LIFO recapture provisions contained in the above legislation. These recapture provisions introduce an unprecedented and highly controversial departure from longstanding principles of taxation for liquidating companies employing the Last-In, First-Out (LIFO) method of inventory valuation.

The provisions were added by Senate floor amendment without the benefit of committee hearing on the merits. The Conference Committee agreement states that the effective date was delayed to allow for Congressional hearings to be held on these provisions. No hearings have yet been held and the provisions are scheduled to become effective January 1, 1982.

We strongly support HR 4717 and HR 5011. The one-year delay these bills provide for would allow the necessary time for full hearing on the merits of the legislation.

The attached memorandum more fully discusses some of the major issues we believe need to be addressed in Congressional hearings.

Very truly yours,

BYRLE M. ABBIN.

Enclosure.

MEMORANDUM IN SUPPORT OF H.R. 4717 AND 5011—DELAYING THE EFFECTIVE DATE OF THE LIFO RECAPTURE PROVISIONS OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980

We are concerned that the amendment made by § 403(b) of the Crude Oil Windfall Profit Tax Act of 1980 will become effective January 1, 1982 without the benefit of Congressional hearings on the merits of these changes. It is with this concern that we submit the following comments in support of H.R. 4717 and H.R. 5011 deferring the effective date of the LIFO recapture provisions.

Arthur Andersen & Co. is an international firm of accountants with offices throughout the United States and various foreign countries. While we have many clients who may potentially be affected by these provisions, these comments are not on their behalf, and are the views of the firm itself.

BACKGROUND

Public Law 96-223, signed on April 2, 1980, and cited as the "Crude Oil Windfall Profit Tax Act of 1980," contains non-energy related provisions which were added by the Senate as Amendment No. 592 to the House Bill. No hearings were held with respect to the amendment. The only modification made by Conference Committee concerned postponesment of the effective date of its provisions to plans of liquidation adopted after December 31, 1981. The Conference agreement states "(t)he effective date was postponed to allow for Congressional hearings on this provision.

These provisions, embodied in Act § 403(b), introduce an unprecedented and highly controversial departuer from long-standing principles of taxation for liquidat-

ing companies employing the Last-In, First-Out ("LIFO") method of inventory valuation.

No hearings have yet been held on those provisions. The present bills also do not provide for a hearing on the merits. Considering their dramatic import, we strongly support H.R. 4717 and H.R. 5011, delaying the effective date of those provisions until January 1, 1983. This would allow the time necessary to conduct full hearings analyzing the impact and appropriateness of these provisions.

The balance of this statement develops the background of the LIFO method and addresses some of the issues we believe should be considered in hearings on the merits.

The LIFO inventory method has been available for use by taxpayers in general since the late 1930's. It is a statutory method for determining the flow of costs through inventory and cost of goods sold. It treats the goods sold as those most recently acquired. It considers those still on hand at the end of a taxable year as being those on hand at the beginning of the year, plus increases in the order of acquisitions (along with other permitted computational variations). Its utilization in a period of inflation generally eliminates inflationary profits in inventory by matching the current cost of goods sold with the income it is producing. This reduces income for both financial reporting and Federal income tax purposes below that which would be computed under a First-In, First-Out ("FIFO") method.

The Internal Revenue Code provides in § 336 (enacted in 1954) that no gain or loss will be recognized to a corporation on the distribution of property in partial or complete liquidation. This rule applies, with certain exceptions not related to LIFO inventories, to liquidations covered by §§ 337 or 334(b) (2).

Section 337 provides that where a corporation sells its assets and then liquidates within 12 months, no gain or loss will be recognized to the selling corporation on such sales, including sales of inventory assets in bulk, subject to certain limitations. Gain or loss is recognized toshareholders on the receipt of assets in liquidation in excess of the tax basis in their stock.

Section 334(b)(2) permits substantially the same result where a corporation's stock is sold and the purchaser, with certain qualifying provisions, acquires assets by liquidation of the acquired corporation. In this situation, gain or loss is recognized by selling shareholders on the sale of their stock. Generally speaking, no gain or loss is recognized by the liquidating corporation under § 336 or by the acquiring corporation under § 332.

§ was enacted among other reasons ". . . to permit a corporation which is to be liquidated to arrange for a disposition of its assets so that the proceeds from its disposition may be distributed to the shareholders in liquidation withou incurring a tax at the corporate level on the sale. (Joint Committee Summary of Internal Revenue Code of 1954 (H.R. 8300, p. 41). § 334(b)(2) was enacted not only to provide parallel treatment between sales of assets and sales of stock, but also to adopt the principles derived from litigation under the 1939 Revenue Code (Kimbell-Diamond Milling Co. vs. Comm., 14 T.C. 784, aff'd *per curiam*, 187 F.2d 718 (C.A. 5), *cert. denied*, 342 U.S. 827 (1951)).

The liquidation provisions enacted by Congress in 1954 were clearly intended to both provide consistency and reduce the level of taxation of corporate profits where sales or liquidations are involved. In each of the previously described liquidations, the selling shareholders recognize and are taxed on the gain realized upon termination of their ownerhship of the stock of the liquidating corporation. The cash and property received by the shareholders reflect the current value of all assets of the liquidating corporation as determined by arms-length negotiation between the buyer and seller. The gains taxed at the shareholder level represent the difference between the value of cash and property received and the shareholders' basis in the stock of the liquidating company.

Certain exceptions to the single level of taxation principle are embodied in the statute and in case law that later developed. § 337 does not permit a liquidating corporation to escape corporate taxation on inventory sales in the ordinary course of business during the last 12 months of its existence. On the othe hand, a bulk sale of substantially all of a corporation's inventory to one buyer after adoption of a plan of liquidation under § 337 is not taxed at the corporate level. Additionally, §§ 1245 and 1250 provide that the gain on the disposition of depreciable property that relates to prior depreciation deductions (with significant exceptions related to holding period and method of depreciation) are taxed to the corporation at ordinary income rates. These provisions are designed to "recapture" the benefit of excess depreciation deductions and apply to a sale or liquidation under §§ 337 and 334(b)(2).

The Courts and the Internal Revenue Service have added the "tax benefit rule" to modify the previously cited exceptions to corporate non-recognition in §§ 337 and 334(b)(2) liquidations. The "tax benefit rule" provides that the recovery of an

amount that was deducted from income in a prior year must be treated as income in the year recovered to the extent the deduction resulted in a tax saving. The "tax benefit rule" has been applied by the Internal Revenue Service to "recapture" items previously expensed for which an economic value exists and is realized by a liquidating corporation, similar to the recapture of excess depreciation under §§ 1245 and 1250.

WINDFALL PROFIT AMENDMENTS

Section 403(b) of the Windfall Profit Tax Act amends §§ 336 and 337 of the Internal Revenue Code to cause the "recapture" of LIFO inventory "profits" at the time of liquidation. The "LIFO recapture amount" is defined under § 336(b)(3) to be the amount by which "the inventory amount of the inventory assets under the first-in, first-out method authorized by § 471, exceeds the inventory amount of such assets under the LIFO method". § 337(f) states that the non-recognition provisions of § 337 apply only to the extent the gain from the sale or exchange of inventory assets exceeds the LIFO recapture amount. These provisions cause the recognition of gain in a § 337 (or § 334(b)(2)) liquidation equal to the differential between LIFO and FIFO inventory values.

REPEAL OF PROVISION

We believe the effects of these amendments are punitive, unwarranted, and should be repealed. They represent the reversal of fundamental tax principles that have been in effect for over 25 years and are based upon a clear misconstruction of prior limitations to the non-recognition provisions of §§ 337 and 334(b)(2).

The Treasury Department, speaking in favor of the liquidation amendments, adopted the view that LIFO is essentially a method of deferring profits. Further, Treasury made the "LIFO recapture amount" analogous to the recapture of excess deductions under the "tax benefit rule" and §§ 1245 and 1250, arguing that the LIFO recapture amount is eliminated permanently from taxation. Such a view fails to recognize that the differential is taxed at the shareholder level as part of the capital gain upon liquidation, consistent with Congress' longstanding intent to effect taxation only at the shareholder level in a corporate liquidation.

Under the rules as enacted, it appears as though income may be recognized in such a liquidation even where there is no gain and the shareholder suffers a loss with respect to the sale or liquidating stock distributions, since, unlike §§ 1245 and 1250, §§ 336(b) and 337(f) do not limit the gain recognized to the overall gain realized by the shareholder. The taxpayer may have no real economic accretion to wealth but would, nontheless, be subjected to tax under these provisions.

The "recapture" of the differential that results from use of the LIFO inventory method is not analogous to the recapture of excess deductions which occurs under §§ 1245, 1250 and the "tax benefit rule". As previously stated, LIFO is a method of sequencing the flow of cost through inventory and represents the only permitted means of determining the true cost of inventory when the use of the method is elected. The first-in, first-out (FIFO) method similarly is no more than a method of sequencing the flow of cost through inventory. Neither method purports to ascertain the exact physical identity and actual cost of each item in inventorty. Neither method results in the reduction of historic cost (similar to depreciation deductions recaptured under §§ 1245 and 1250), or the omission of asset costs from the balance sheet of a liquidating company (similar to a premeture expensing of items recoverable under the "tax benefit rule"). Prior to the enactment of § 403(b), the Internal Revenue Service has recognized this fact through publications and adherence to Rev. Rul. 74-431 (1974-2CB,107) which addresses the application of the "tax benefit rule" to LIFO in a § 337 liquidation and concludes . . .

"(A)ccordingly, the 'tax-benefit rule' does not apply to the bulk sale of LIFO inventory pursuant to a plan of liquidation under § 337 of the Code."

The amendments to IRC §§ 336 and 337 introduced by Windfall Profit Tax Act § 403(b) represent unsound tax policy. Basically, they constitute a tax on inflation at the time when inflation is consistently running at a double-digit rate. The LIFO method was designed to eliminate from taxable income inflation induced inventory profits. The LIFO method represents the only attempt that exists today in the entire body of tax law to mitigate the effects of inflation. To tax the difference between the cost of LIFO inventory and its current value appears to make no more sense from a tax policy standpoint than to tax the excess of the current value of land over its cost.

These amendments will no doubt have their greatest applicability to smaller family or management owned companies. Often the main or overriding considera-

tion in the sale of assets of a closely held business following the adoption of a plan of liquidation under § 337 is the need for liquidity in the estate of the owner. These amendments will place an additional tax on the owner in order to achieve that liquidity that has never existed before. (Even if shares are sold rather than assets, the buyer will no doubt discount the consideration paid to the extent that additional tax would later be due in a liquidation to which § 334(b)(2) would apply.) These tax burdens will not be felt by larger publicly traded companies since their shareholders have a ready market for satisfaction of liquidity needs, and they are not forced to proceed with transactions that fall within the reach of the amendments.

We believe that a serious error was committeed by attaching these non-energy related LIFO provisions to the Windfall Profit Tax Act without full and meaningful deliberation by both Congressional tax committees and the opportunity for testimony and hearings on all aspects of the proposal. The changes effected by these amendments are far-reaching and represent the reversal of fundamental tax principles that have been in effect for over 25 years. We believe they represent unsound tax policy and their effective date should be delayed to allow Congress to properly consider the merits of the provision.

This memorandum was prepared by James E. Bushman, Head, Firm Practice Specialty Team—Tax Accounting Methods. Mr. Bushman is located at Arthur Andersen & Co., 425 Walnut Street, Cincinnati, Ohio 45202, (513) 381-6900.

ASSOCIATED EQUIPMENT DISTRIBUTORS,
Oak Brook, Ill., December 9, 1981.

Hon. DANIEL ROSTENKOWSKI,
House Ways and Means Committee,
Longworth House Office Building
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: AED is an association composed of over 1,500 distributors and manufacturers of construction equipment from across the country. At this time, we are writing to you in order to express AED's support for those measures, including HR. 4717 and HR. 5011, which would defer for one year the effective date of the so-called "LIFO recapture" provision of the 1980 Crude Oil Windfall Profits Tax Act.

Many of our members use the LIFO system of accounting. If the "LIFO recapture" provision is allowed to go into effect as scheduled at the end of the year, these members, many of whom are small, family-owned businesses, will be adversely affected to a severe degree. As you know, this provision would require a firm to repay those taxes which were saved by using LIFO when it liquidates its business inventory. We believe unlike the Treasury Department, that the LIFO method of accounting more accurately estimates the value of the inventory during inflationary periods, so a recapture is, in fact, excess taxation.

AED believes that a delay in the implementation date would give Congress the times necessary to study this critical area of the law. Until now no extended consideration has been given to the effects of the recapture provision. LIFO recapture was constructed exclusively by the Treasury Department and included in the Windfall Profits Tax Bill as a result of a compromise on the Senate Floor. Neither the Ways and Means Committee, nor the Senate Finance Committee, ever held hearings on this provision. It was for this very reason that the effective date for "LIFO recapture" was postponed for two years, in order to give Congress time to hold hearings and to study this issue. Unfortunately, no such hearings were ever held.

AED believes that a postponement in the effective date is essential. AED further believes that once the issue has been studied, Congress will realize that the inclusion of a "LIFO recapture" provision was ill-advised and will act promptly to repeal it in its entirety. We look forward to your cooperation in this effort.

Sincerely,

JOHN T. O'LEARY,
Manager, Washington Services.

BAKER & HOSTETLER,
Washington, D.C., December 8, 1981.

Re Public Hearing on LIFO Recapture—H.R. 4717 and H.R. 5011.

COMMITTEE ON WAYS AND MEANS PR # 13,
U.S. House of Representatives,
1102 Longworth House Office Building,
Washington, D.C.

DEAR SIRS: I wish to express concern about the proposed one-year deferral of the effective date of the LIFO recapture provisions of the Crude Oil Windfall Profit Tax Act of 1980 Public Law 96-223).

It has been my experience in representing small and middle size corporations that considerable pressure has been put upon some of them to sell their businesses before the end of 1981 in order to avoid income tax upon recapture of LIFO inventory which would be generated from the sale of their businesses under newly enacted law. Such recapture would now occuron sales and liquidations effected after 1981.

It is believed that the in terrorem effect of the new legislation is forcing sales or liquidations of businesses which otherwise might not take place or at least might not be completed on a "shot-gun" basis. This unfortunate result is likely to be repeated if the extension of the effective date of the LIFO recapture provision is limited to one additional year, until 1983, as presently proposed.

It would be my suggestion that the new LIFO recapture provision be suspended for two years, until January 1, 1984, so as to reduce this unforeseen impact upon smaller and middle size businesses. Moreover, a two-year suspension would be consistent with similar treatment (2-year suspension, subsequently reneweed twice) of the effective date of the new provisions with respect to limitations on net operating loss carryovers under Section 382 of the Internal Revenue Code.

Very truly yours,

HARLAN POMEROY.

JOSEPH BARNES & ASSOCIATES,
Fort Lauderdale, Fla., December 4, 1981.

Re LIFO Recapture H.R. 4717 & 5011.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
1102 Longworth House Office Building,
Washington, D.C.

GENTLEMEN: Please approve HR 4714 and 5011. Then abolish, not defer the effective date of the LIFO Recapture provision of the Crude Oil Windfall Profit Tax.

Recognition of LIFO Inventory Recapture in the case of liquidations is not only manifestly unfair because it taxes inflation gains at ordinary tax rates rather than at capital gain rates, it is also utterly inconsistent with the Code's requirement that no other method of inventory may be used for reporting to the company's creditors and shareholders when the LIFO method is used.

In point of fact, the Code requires that taxpayers deducting the difference between FIFO and LIFO inventory from taxable income must pretend in their financial reports that LIFO is the only true inventory. It is the only inventory method allowed to be used for financial reporting. This results in reportable profit well below (in many cases) those profits determined on a FIFO basis. Taxpayers using LIFO bear this cross of hamstrung financial reporting because the tax benefits of being able to write off the cost of inflation are essential to their survival in a world of high inflation.

The LIFO recapture legislation of 1980 presents an inconsistent set of rules governing LIFO. The recapture rules really say that LIFO is not the only true inventory. The rules say that there really is more inventory than is shown when LIFO is in use. They say that this "extra" inventory, (which was clearly produced solely by inflation) must be taxed upon liquidation at ordinary tax rates!! How absurd!! First the rules make a rigid pretense of the non-existence of the "extra" inventory and now they want to tax that very non-existent inventory; and at ordinary rates! Every other business asset with a gain due to inflation gets capital gain treatment on the gain. But not LIFO inventory! No!! The poor, beaten down businessman! The manufacturer, the retailer, the wholesaler—he pays a double digit prime rate to finance purchases; he pays lease payments to warehouse and merchandise products with his rent escalating every year; his cost of goods spiral; and with much wisdom Congress gave him a break. LIFO!

Now some members of Congress want to take it away.
Please don't let that happen.
Very truly yours,

JOSEPH B. BARNES.

BORG-WARNER CORPORATION,
Chicago, Ill., December 3, 1981.

Hon. DAN ROSTENKOWSKI,
U.S. House of Representatives,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: I urge your consideration and support of HR 4717 scheduled for hearing and mark-up on December 9, 1981. As you know, this bill would postpone implementation of LIFO recapture to December 31, 1982 to allow time for Congressional hearings as provided for in the Conference Agreement of the Windfall Profits Tax Act of 1980.

Sincerely yours,

DENNIS W. KROL,
Manager, Federal Taxes.

STATEMENT OF ERNST & WHINNEY

We are pleased that the Ways and Means Committee has scheduled hearings on H.R. 4717 and H.R. 5011. We believe that one of the bills should be passed in order to ensure that Congress has adequate time to consider the issue which they address and we urge immediate enactment.

Both H.R. 4717 and H.R. 5011 would delay for one year, until December 31, 1982, the LIFO recapture provision that was added to the Internal Revenue Code by Section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980 (1980 Act). Immediate enactment of H.R. 4717 or H.R. 5011 will put an end, at least for the time being, to the uncertainty that this provision has created for affected businesses. The mere threat of recapture is already causing some businesses to consider a liquidation which might not otherwise be necessary.

The LIFO recapture provision was included in the 1980 Actas a Senate floor amendment, with a delayed effective date. It applies to distributions in a complete or partial liquidation which occur pursuant to a plan adopted after December 31, 1981. The provision was developed by the Treasury Department as part of a compromise and did not have the benefit of separate hearings by either the House Ways and Means Committee or the Senate Finance Committee. As a consequence, it did not receive the full consideration that such a broad tax policy issue should have before it is implemented. The Conference Committee accepted the provision, but with a deferred effective date, in recognition that it was intended that hearings would be held before the provision took effect.

We believe the recapture provision creates several inequities which should be the subject of hearings before the provision becomes effective. In this connection, this provision may result in taxation of amounts greater than the reduction in taxable income from having used LIFO; it appears retroactively to LIFO inventories accumulated in years before the date of enactment; it discriminates against the corporate form of organization (especially small corporations); and it applies to taxpayers in all lines of business—not just those who have oil and gas inventories on LIFO. Obviously, those other taxpayers could not reasonably have been expected to provide input to the Congress on a 1980 Act which ostensibly did not have a direct impact on their tax position.

The Economic Recovery Tax Act of 1981 directed the Treasury Department to conduct a full and complete study of inventory matters generally, and LIFO in particular, for the purpose of developing simplified methods of accounting for inventory. That study is due to be completed by December 31, 1982 and provides the Treasury Department with an opportunity to present its views on the LIFO recapture provision. Once this study is available, Congress and the public will be in a better position to evaluate the merits of this provision as well as other important LIFO matters.

Finally, in view of the fact that hearings have not yet been held and because the time remaining in this session does not permit careful consideration of this important matter, we believe a one year postponement of the LIFO recapture provision is in the public interest. Thus, we fully support the passage of either of the above bills.

88-547 O—82——7

If we can be of any assistance to you or your committee in this matter, please contact Herbert J. Lerner, Partner-in-Charge of our National Tax Department, Washington Office, at 862-6258.

STATEMENT OF HARRY SULLIVAN, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, FOOD MARKETING INSTITUTE

Food Marketing Institute appreciates this opportunity to submit comments on H.R. 4717, a bill to defer the effective date of Section 403(b) of the Windfall Profit Tax Act of 1980. The Food Marketing Institute (FMI) is a non-profit association that conducts programs in research, education and public affairs on behalf of its 1100 members—food wholesalers and retailers and their customers. FMI's domestic member companies operate over 17,000 retail food stores with a combined annual sales volume of $117 billion—half of all grocery sales in the United States. More then three-fourths of FMI's membership is comprised of independent supermarket operators or small regional firms.

It is especially on behalf of FMI's smaller members that we urge passage of H.R. 4717 which will delay for one year the implementation date of Section 403(b). This delay is essential to provide time for hearings on the merits of this section. Without an extension, this provision goes into effect January 1, 1982.

Section 403(b) provides for taxing a LIFO reserve at ordinary income rates upon the liquidation or partial liquidation of a company. In effect it will create double taxation of inventory "gains" caused by inflation for taxpayers using the LIFO inventory method when firms are sold.

Since 403(b) was added as a floor amendment at the request of the Treasury Department and was vigorously opposed by the business community (particularly small and family-owned businesses), Congress postponed the effective date for two years to allow time to hold hearings on the merits of the issue and determine the efficacy of the provision. Hearings have not been held, and in light of the congressional schedule there is little likelihood time can be found for needed indepth hearings prior to the implementation date. It is for this reason FMI encourages passage of H.R. 4717.

FMI's longer run interest is to seek the repeal of Section 403(b) as the provisions of this section will be clearly discriminatory to smaller businesses which use the LIFO accounting option. The discrimination will result from the fact that smaller busineses tend to be liquidated or terminated more frequently than larger businesses. There are hundreds of thousands of small businesses in existance and thousands more which are initiated each year. Congress, in its wisdom, frequently has encouraged the formation of new business and the protection of existing small businesses with special legislation.

In the recent Economic Recovery Tax Act of 1981, Congress provided special legislation which will make feasible the use of LIFO acounting by very small businesses. LIFO accounting helps avoid paying tax on illusory profits during periods of inflation. Furthermore, Congress instructed the Secretary of the Treasury to do an indepth study geared toward further simplification of LIFO application for other businesses.

This is extremely important as most small businesses currently cannot afford to use LIFO accounting because of the costs involved. It is estimated that more than 95 percent of small business remain on FIFO. However, when LIFO simplification is achieved, as is the objective of the Congress, it is expected most smaller, as well as medium sized firms, will elect the LIFO accounting option.

It is very important to keep in mind that many people go into business with the clear and express purpose of building a business which eventually can be sold-out to finance their retirement. It is very important to the economic health of the country that potential entrepreneurs have strong incentives to enter into business. This is the essence of competition. Recapture of LIFO tax benefits certainly would be counter-productive in this regard.

Again, FMI urges that H.R. 4717 be enacted prior to December 31, 1981 so as to delay until January 1, 1983 the implementation of Section 403(b) of the Crude Oil Windfall Profits Tax of 1980. (Public Law 96-223.) FMI further urges that the House Ways and Means and the Senate Finance Committees hold hearings in early 1982 on the merits of Section 403(b). It is our sincere conclusion and desire that once the negative implications of this section are understood that repeal of Section 403(b) will be deemed in wisdom.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., December 9, 1981.

Re repeal or deferral of "LIFO recapture" provisions of Crude Oil Windfall Profit Tax Act of 1980: H.R. 4678, H.R. 4717 and H.R. 5011.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives,
1102 Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to present for the public record its views to the House Committee on Ways and Means concerning various bills—H.R. 4678 of Congressmen Gibbons, H.R. 4717 of Congressman Jenkins, and H.R. 5011 of Congressman Gradison—to repeal or defer the effective date of the "LIFO recapture" provision of the Crude Oil Windfall Profits Tax Act of 1980 (Public Law 96-223).[1] MAPI commends the Committee for its diligence in reconsidering the LIFO recapture subject prior to its effective date (i.e., for dispositions pursuant to plans of liquidation adopted after December 31, 1981), as was intended by the House-Senate conferees who acted on the matter in the 96th Congress.[2]

To state our position in brief, Section 403(b) of Public Law 96-223 is a case study in questionable policymaking occasioned by a nongermane Senate floor amendment to an unrelated bill that precluded participation by either the public or the standing Committees of Congress in the formulation of the item. We believe it can be demonstrated that the LIFO recapture here in issue constitute unsound tax policy and is not consistent with the trend of changes in federal income taxation toward the elimination of inequitable inflationary side-effects. Moreover, the history of the provision indicates that it was a revenue expediency proposed by the last Administration behind closed doors as consideration for an oil-tax concession sought by Senator Stevens of Alaska.[3]

We believe that LIFO recapture is without merit and deserving of prompt repeal. However, we urge the Committee at the very least to delay the effective date of the provision if doubts still exist after the current proceeding. Time is of the essence, and we recognize that a postponement pending further deliberations may seem more practical to some Committee members.

BACKGROUND

Current law

As partly set forth in the Conference Report on Public Law 96-223, a liquidating corporation currently will not recognize any gain or loss on the transfer of its inventory to its shareholders as part of the liquidation. Also, a corporation that sells its assets during a 12-month liquidation under Code Section 337 will not recognize any gain or loss on the bulk sale of its inventory. In either case, if the liquidating corporation accounts for its inventory on the LIFO method, any gain attributable to the excess of the adjusted basis of the inventory under the FIFO method over its LIFO adjusted basis will not be subject to corporate tax. However, if a subsidiary corporation liquidates into a parent corporation and the adjusted basis of the subsidiary's assets carry over to the parent, the LIFO reserve will be taxable when the inventory is disposed of in a taxable sale or exchange.

The amendment

As amended on the Senate floor and subsequently enacted, Public Law 96-223 states in part that a corporation that distributes its LIFO inventory in a partial or complete liquidation of the corporation must recognize the inventory's "LIFO recapture amount"—i.e., the excess of the adjusted basis of the inventory under the FIFO method over the LIFO adjusted basis—as ordinary income. Also, a corporation that sells its LIFO inventory in the course of a 12-month liquidation under Code Section 337 must recognize the inventory's LIFO recapture amount as ordinary income. However, the LIFO recapture amount need not be recognized on corporate liquidations where the adjusted basis of the LIFO inventory in the hands of the acquiring corporation is carried over from the liquidating corporation.

Effective date.—Barring further action by Congress to repeal, amend, suspend, or delay the new LIFO recapture rules, they will be effective for distributions and

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[1] In asmuch as the bills basically involve either a repeal or a suspension of LIFO recapture, they are not described herein in further detail.

[2] House Report No. 96-817 (96th Congress, 2nd Session), March 7, 1980, at page 161.

[3] In so stating, we do not imply that the oil-tax concession was inappropriate. Our position is that, if a revenue offset was needed, some mechanism other than LIFO recapture should have been proposed.

dispositions made pursuant to plans of liquidation adopted after December 31, 1981. A delayed effective date was assigned to these LIFO changes to allow time for congressional hearings and to allow transactions in the planning stage to be completed.

FURTHER COMMENTS

Our further and more detailed comments deal with (1) legislative procedure; (2) the "Stevens Amendment"; (3) taxation in the event of liquidation; (4) LIFO and "inventory profits"; and (5) directions in LIFO inventory accounting policy generally.

Legislative procedure

The legislative procedure used to enact Section 403(b) of Public Law 96-223 fell somewhat short of the constitutional due process that should apply in the enactment of federal laws. Indeed, there was practically no such legislative process. LIFO recapture was not considered by the House Committee on Ways and Means and was not reviewed by the Senate Committee on Finance. Nor was the public afforded an opportunity to present its views on the subject although significant numbers of taxpayers were understood by Treasury officials of the last Administration and by some Senators and House members to be exposed adversely by the measure. In our opinion, substantive changes in federal laws should not be enacted using truncated procedures. Although this should be self-evident in all contexts, it emerges in bold where tax policy is involved. LIFO inventory accounting is sufficiently complex to warrant cautious and thorough examination by all interested parties.

As stated earlier, LIFO recapture was a nongermane Senate floor amendment to a bill well on its way toward enactment to accomplish wholly unrelated purposes, and the public did not have a chance to express itself "for" or "against." We believe that this procedure was fatally defective, and that the conferees did not rectify matters by recommending passage and then postponing the effective date. Our preference would have been for the Senate conferees to have receded to their House counterparts, with any further examination of LIFO recapture to have been taken up separately following normal procedures in connection with revenue bills before the 97th Congress. We think it unfortunate that the dialogue now is in terms of whether to repeal or delay the provisions whereas the inquiry under full legislative process would have been whether to enact it at all.

We are not unaware that legislation by floor amendment occurs with some frequency. Also, we appreciate that the effects for taxpayers sometimes are favorable as well as adverse. At the same time, we find the practice hard to defend where significant substantive changes are in question, and we believe that the aggrieved parties have standing to object. In our opinion, Committee members should view Section 403(b) as suspect because of procedural shortcomings as well as tax accounting deficiencies. Also, we feel that members of the tax-writing Committees should resolve to avoid short-circuited procedures in connection with complicated tax policy proposals.

The "Stevens amendment"

As noted, Section 403(b) of Public Law 96.223 was part of an amendment offered to H.R. 3919 on the floor of the Senate. The history of the provision casts further doubt on it, as will be seen.

It is a matter of public record that an objective of Senator Ted Stevens (R.-Alaska) with respect to the proposed Crude Oil Windfall Profit Tax Act as it headed toward Senate floor debate was to relieve oil companies of requirements to recognize income for tax purposes in the event of involuntary liquidations. More specifically, if petroleum product inventories accounted for by the LIFO method were to have been sold but not to have been replaced because of foreign trade interruptions or government regulations, the usual income-recognition effects of penetrating earlier, lower-cost inventory layers were to be disregarded provided that the depleted inventories would be replenished within a stipulated period of time. Such a provision was justifiable under the circumstances, and had legislative precedent during World War II and the Korean conflict—periods of similar turbulence and uncertainty in markets for "strategic" products.

When Senator Stevens inquired as to the Treasury Department's position regarding his proposed amendment, Treasury replied that it would not oppose the provision if the Senator would add to it an item designed to recapture LIFO inventory profits in the event of ordinary liquidations. Treasury estimated that LIFO recapture would bring into the government's coffers approximately $40 million of new

revenues annually. Whether Senator Stevens considered LIFO recapture to be unimportant to his constituents or simply a fair exchange for Treasury's withdrawal of actual or potential opposition to an involuntary liquidation item is not clear. In any event, LIFO recapture became part of the Stevens amendment and was appended to H.R. 3919 in the Senate. The Senate floor discussion of Treasury's portion of the amendment was cursory, to say the least, and the item was neither "debated" nor described carefully.

It would not be unfair to conclude that most individuals voting in favor of the Stevens amendment were relatively unfamiliar with the LIFO recapture element, and relief considerably on summary assurances provided by the floor manager. In other words, the public record under lying LIFO recapture is virtually nil.

Liquidations

As already noted, Section 403(b) of Public Law 96-223 will—if allowed to go into effect—require that a corporation distributing its LIFO inventory in a partial or complete liquidation recognize the inventory's LIFO recapture among as ordinary income. The same recognition would apply in the course of a 12-month liquidation under Code Section 337. The practical effect of this will be to recapture LIFO reserves under both Code Sections 334(b)(2) and 337. This is inconsistent with longstanding tax policy. Also, we see no sound reason for an ad hoc change to tax law that has been in place for some 27 years and survived repeated congressional reviews of liquidation and inventory accounting procedure.

Under Section 336, gain or loss generally is not recognized to a corporation upon the distribution of property in partial or complete liquidation, and this rule normally is applicable to liquidations under Section 337 and 334(b)(2). Section 337 allows a corporation to dispose of its assets and then liquidate within 12 months without recognition consequences, including specified bulk sales of inventories. Such gain or loss as there may be is recognized by shareholders when they receive assets in redemption of their stock. Under Section 334(b)(2), a similar result is obtained where stock is acquired and the purchaser acquires assets by liquidating the acquired enterprise. Although the corporate purchaser is accorded nonrecognition and a changed basis in this instance, it experiences gain or loss upon the subsequent sale of its stock.

The fundamental policy behind Section 337 was to permit a company that is to be liquidated to arrange for a disposition ofits assets so that the proceeds may be distributed to the shareholders in liquidation without taxation at the corporate level. The main idea behind Section 334(b)(2) was to provide parallel tax treatment where either (1) the assets of a corporation are purchased directly by the taxpayer enterprise, or (2) the taxpayer enterprise acquires the stock of another company and then liquidates it to obtain the assets.

In our opinion, the liquidation policies described above are sound and were enacted, after careful deliberation, to avoid overlapping taxation at the corporate and shareholder levels with respect to inventory "appreciation" that has not been realized. Certainly, liquidation policy should not be such as to subject gains or losses to tax recognition twice. Also, we should think that transactions differing in form but having identical effects should be treated as nearly alike for tax purposes as circumstances will allow. Although LIFO recapture would not necessarily offend the symmetry objective, we believe that double tax implications, or something akin thereto, would flow from the device.

Moreover, we cannot accept that the absence of LIFO recapture in the content of Code Sections 337 and 334(b)(2) was an inadvertent omission. As to Section 311(b) dealing with the recognition of gain on a distribution of LIFO inventory—also enacted as part of the Revenue Act of 1954—it would seem clear from the existence of recapture in one distribution provision but not in another that Congress intended to distinguish between the tax effects (i.e., for corporations and recipients) of distributions generally and those made in the context of liquidations.

LIFO and "Inventory Profits"

The essence of LIFO as an ordering rule for inventory identification is its ability to squeeze most "inventory profits" out of reported results of operations for tax and financial purposes. Of course, inventory profits are not profits at all, but are phantom amounts that otherwise would be reported as income in an inflationary environment due to understated costs of goods sold.

Contrary to some opinion, the LIFO reserve is not a windfall to the taxpayer; is not profit; is not income by any definition; and certainly is not taxable inocme in any economic sense. LIFO recapture would impose taxes on the reserve even though LIFO has been in place for some 60 years for the purpose of preventing such taxation in the normal instance of a business operating in an economy where the

general purchasing power of the currency is declining. We content that the LIFO reserve is no less a phantom sum in the case of a liquidation uder Code Section 337 or 334(b)(2) than in the instance of a going concern.

Stated another way, the principal reason for LIFO is to minimize the imposition of federal income taxes on "nominal" (as compared to real, "adjusted," or "deflated") income in order to allow actual costs to be recovered and to prevent the erosion of capital through the taxation of amounts that do not actually constitute income. This is no less true because a reduction of LIFO inventory happens to result in a recognition of income. Also, it is no less true because recapture occurs upon liquidating sales of non-corporate entities. Also, in the liquidation context, we do not agree that the single incident of having inherited a transferor's basis or having a stepped-up one should be dispositive as to whether *non*-income should be taxed.

LIFO directions

As the Committee is aware, LIFO has a long history of general acceptance for tax and financial purposes, and LIFO usage is expanding rapidly as inflation continues at relatively high rates. Also, there are pressures to simplify and extend LIFO accounting so that it is more readily available to all enterprises wishing to elect to use it. Indeed, a study of LIFO was commissioned as part of the Economic Recovery Tax Act (ERTA) of 1981, reflecting certain of these objectives, and other ERTA changes in LIFO accounting—not to mention those accomplished administratively and by court decision—have reinforced the trend. Meanwhile, the tax system is being modified in other respects to abate the perverse effects of inflation for corporations and individuals subject to the federal income tax system, including accelerated cost recovery for depreciable assets, improved tax credits for qualifying assets, reduced marginal rates for individuals, indexation, and other provisions.

LIFO recapture strikes us as being anachronistic, and does not seem consistent with the current direction of tax policy in this area.

CONCLUSION

We urge the Committee to give favorable consideration to repeal of Section 403(b) of Publil Law 96-233 or, at the very least, to suspend its effective date until the tax-writing bodies in the House and Senate can devote proper attention to the subject. In our opinion, there is no excuse for continuing in the federal statute books a tax provision—whether in effet of in suspense—that was not given appropriate legislative process and that seems ill-conceived on its face. Furthermore, taxpayers making dispositions pursuant to plans of liquidations adopted after December 31, 1981, should not be required to take into consideration a LIFO recapture provision that was enacted without due process and given only superficial review in the current proceedings.

MAPI is grateful to the Committee for this opportunity to express its thoughts on a matter of mutual interest.

Respectfully,

CHARLES STEWART,
President.

MAIN HURDMAN,
New York, N.Y., November 25, 1981.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
1102 Longworth House Office Building,
Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: In connection with the public hearing which your Committee will hold on December 9, 1981, on behalf of my firm, Main Hurdman, I wish to make the following comments. When the crude oil Windfall Profit Tax Act of 1980 was enacted, Section 336(b) was, as a result of a Senate floor amendment, added to the Internal Revenue Code. This section, in certain sales of all assets of a corporation, provides for the recapture of the tax savings realized by that corporation through the use of the Last In First Out (LIFO) method of valuing inventories. However, since the section was enacted without the benefit of any public consideration of its merits, Congress, recognizing that this amendment had a potentially greater impact than originally foreseen, delayed the effective date of the provision until January 1, 1982.

Unless action is taken now, this provision will become operative without a full investigation of all its implications. This is contrary to the intent of the Congress as expressed in the Economic Recovery Tac Act of 1981 Section 238 when it mandated

a ". . . full and complete study of methods of tax accounting for inventory . . ." by the Secretary of the Treasury. This review is to be completed by December 31, 1982. In addition, the Economic Recovery Tax Act of 1981 (Sections 235-236) made the LIFO inventory method more readily available to small business. To permit Section 336(b) to become effective on January 1, 1982 will frustrate that effort.

On behalf of Main Hurdman, which is a national firm of Certified Public Accountants with offices in 80 locations throughout the United States. I urge that the changes in Section 336 enacted in the Windfall Profit Tax Act of 1980 be repealed before it becomes effective. Or, considering the mandate expressed in the Economic Recovery Tax Act of 1981, it should be delayed in taking effect until the Treasury review of tax accounting for inventories is completed.

When effective, Section 336 would, in our judgment, undo the reasoned benefit presently conferred on taxpayers by long standing sections of the Internal Revenue Code. Its effect would be to tax dispositions of LIFO inventories on: (1) the sale by a corporation of all its assets in a situation where Section 337 of the Internal Revenue Code would apply and (2) the distribution of LIFO inventories in a liquidation which would qualify for the benefits conferred by Section 334(b)(2) of the Internal Revenue Code. Both Section 337 and Section 334(b)(2) were enacted into law after much deliberation by the Congress in an attempt to enable taxpayers to accomplish stated objectives without being hampered by legalistic formalities which did not truly reflect the transaction which was occurring.

Section 334(b)(2) of the Code was enacted to enable a willing seller to sell the assets of a business to a willing buyer by the simple format of selling the stock of the corporation rather than by selling each individual asset of that corporation. Section 334(b)(2) was the codification of a well known tax case which was decided under the 1939 Revenue Act, *Kimball-Diamond Milling Company* v. *Comr.*, 14 TC 74 (1950), aff'd per curiam, 187 F. 2d718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951). This section recognized both the practicalities and the substance of a situation wherein a purchaser purchasing the business of a corporation would accomplish the same end result whether he bought the assets of the business directly or the stock ownership. The provision has been an effective tool in enabling the owners of U.S. business to dispose of the fruits of their labor without being overly concerned with legalistic formalities.

Similarly, Section 337 has recognized over the years that a sale by a corporation of all its assets and its liquidation and distribution of those assets to its shareholders within a twelve-month period should not result in both a recognized gain to the corporation and a recognized gain on the liquidation to the shareholders.

Section 336 has far reaching ramifications. When effective, it will materially change, without the benefits of comments from the interested public, provisions in the corporate liquidation areas of the Internal Revenue Code that have remained substantially unchanged since their enactment in 1954. It potentially affects every corporation regardless of size. It would resurrect the very legalistic pitfalls that the original enactment of the sections were intended to cure. As a result, the tax treatment of a corporate liquidation will depend on the sophistication of the directors and their tax advisers, rather than on the actual substance of the transaction. I do not think this result is one you and your fellow committee members desire.

As William Raby, Chairman of the American Institute of Certified Public Accountants, so succinctly stated in a letter to you dated October 28, 1981:

"The LIFO recapture provision [Section 336(b)] changes the basic pattern of taxation of corporate liquidations by taxing the unrealized appreciation in a single asset at both the corporate and shareholder levels. Inventories alone have been singled out for this changed treatment, with unrealized appreciation in other assets continuing to be taxed only at the shareholder level. Normally, when a corporation liquidates, Section 336 provides that the appreciation in value of corporate assets is recognized at the shareholder level and not at the corporate level. Section 336, which has been in effect since 1954, was intended to provide simple, consistent tax treatment of liquidations and to reduce the level of taxation in liquidations. The double taxation of unrealized appreciation in inventories is contrary to these desirable objectives of tax policy.

"The double taxation of unrealized appreciation in inventories is particularly offensive in that it is clearly taxing inflationary gain rather than real economic gain. In addition to the inherent unfairness of such a tax, it runs counter to the increasing interest in Congress, in the Administration, and in the business community for tax reforms in the inventory area.

"LIFO is commonly used for tax and financial reporting purposes. It is a method of determining both the cost of inventory on hand and the matching of such costs against revenue in computing income rather than being a deferral of the recognition of taxable income. The recapture provision presently on the books fails to

recognize this important distinction. The LIFO recapture provision does not affect other methods of inventory accounting which could reduce the tax basis of inventories below FIFO cost such as specific identification. Such inconsistent and discriminatory treatment would appear to be wrong on its face.

"The LIFO provision will have a particularly adverse impact on small businesses. A frequent use of the Section 337 liquidation provision is to provide liquidity in the estate of its owner. The double tax will frustrate this objective but will not affect larger businesses because of the marketability of their shares and the normally better access to alternate sources of financing.

"In seeking to avoid the impact of the LIFO recapture provision, small businesses may be encouraged to merge into larger businesses in tax-free transactions."

Our firm is especially concerned as to the impact of this provision on small businesses. Since the recapture provision does not apply to other types of liquidations and reorganizations, it could have the chilling effect of fostering mergers of small businesses into larger corporations not because it makes good economic or business sense, but rather to avoid this additional tax burden.

Although we are prepared to comment on the merits and substance of Section 336, this letter is not the proper vehicle. Our intent at this time is to urge that this provision be deleted from the Code or, in the alternative, the effective date be delayed so that it can be considered by the Treasury in its mandated review of tax accounting for inventories. After such review, if you and your Committee believe that it has merit and should be offered for consideration, it should then be considered separately or as part of other pending legislation to give interested taxpayers and their representatives an opportunity to comment on its merits.

Our firm certainly would appreciate having such an opportunity since we question whether there is a need for such legislation and whether the existing sections are in fact working to accomplish the desired effect sought by Congress when they were originally enacted.

Very truly yours,

FRANCIS M. GAFFNEY,
National Tax Director.

MORTGAGE INSURANCE COMPANIES OF AMERICA,
Washington, D.C., December 3, 1981.

Re H.R. 5013, Federal National Mortgage Association.

Hon. DANIEL ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
Washington, D.C.

DEAR MR. CHAIRMAN: This Association strongly supports the subject bill and urges early and favorable action by the Committee on Ways and Means.

The depressed state of the housing industry has generated increased dependence on the secondary market for residential mortgages. Originators of home mortgages experiencing repeated net outflows of savings have sought liquidity by increased reliance on the secondary markets. In the panorama of secondary market entities, the Federal National Mortgage Association stands out as the most significant; and recovery of the housing industry depends to a great extent on FNMA's continued effectiveness.

FNMA's experience during the last three years with an inverted yield curve has focused attention on an inequity in the Internal Revenue Code. This inequity penalizes FNMA as the only financial institution in the country that is unable to take advantage of the same carryback and carryforward treatment accorded financial institutions under section 172 IRC. At present FNMA may carry losses back three years and forward fifteen years, the tax treatment accorded business generally. However, Congress has accorded financial institutions a ten year carryback and a five year carryforward. This 10-year-5-year formula was accorded financial institutions in 1969 to insure against substantial losses resulting from a downturn in the economy. At that time—1969—FNMA was in a transition status to a wholly owned private corporation. We believe, therefore, that the failure to include FNMA in the legislation affecting other financial institutions was an oversight.

We strongly urge your Committee's early approval of the subject bill so that FNMA will be permitted a needed planning and management tool in 1982 and subsequent years. The recovery of the housing industry in 1982 depends to a great extent on this action by the Congress.

We respectfully request that this letter be incorporated in the record of the hearings on this legislation.

Sincerely,

JOHN C. WILLIAMSON,
Executive Vice President.

STATEMENT OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

The National Association of Manufacturers (NAM) is pleased to submit this statement for the record in support of H.R. 4717 introduced by Congressman Jenkins (D-GA) and H.R. 5011 introduced by Congressman Gradison (R-OH), providing for a one year delay in the implementation of sections 336(b) and 337(f) of the Internal Revenue Code of 1954 (Code). NAM has nearly 12,000 member firms across the country. These firms account for about 80 percent of the nation's industrial output and employ nearly 85 percent of the nation's industrial workforce.

The LIFO (Last-In/First-Out) method is commonly used for tax and accounting reporting purposes. It is a way of determining both the cost of inventory on hand and of matching of such costs against revenues in computing income. As this committee is aware, section 403(b) of the Crude Oil Windfall Profit Tax Act of 1980 (Public Law 96-223) amended Code sections 336 and 337 to provide that a corporation must realize taxable income if it values its inventory under the LIFO method and distributes income as part of a partial or complete liquidation. Under previous law a corporation would not recognize any gain or loss on the transfer of its inventory to shareholders as part of a liquidation.

Advocates of repeal of sections 336(b) and 337(f) have articulated a compelling case. They have argued, and we agree, that the LIFO recapture provisions are clearly contrary to the congressional intent to encourage the wider use of LIFO. Section 238 of the Economic Recovery Tax Act of 1981 (Public Law 97-34), for instance, makes it easier for businesses to convert from the FIFO (First-In/First-Out) accouting method to the more realistic LIFO system. If the LIFO recapture provisions were allowed to go into effect, they would clearly inhibit the use of LIFO. Second, the LIFO recapture provisions change the basic pattern of corporate taxation which is to tax the shareholder for the appreciation in value of corporate assets upon a section 336 liquidation. The LIFO recapture provisions tax the unrealized appreciation in a single asset at both the corporate and shareholder level. This double taxation of unrealized appreciation in inventories is particulary inequitable since it taxes a corporation for inflationary rather than economic gain. Third, LIFO recapture discriminates against those corporations utilizing LIFO as opposed to other inventory methods such as average cost and specific identification. Finally, the LIFO recapture provisions substantially limit the ability of family-owned, closely-held businesses to dispose of assets through any means other than stock transfers. On these grounds we believe that the advocates of repeal have articulated a compelling case for repeal and we feel that the Congress, when it has the opportunity to fully and completely analyze the evidence will vote to repeal the LIFO recapture provisions in Code Sections 336 and 337. In the interim, Congress should defer the effective date of these provisions, as is proposed in H.R. 4717 and H.R. 5011.

One of the most compelling reasons for such a delay is that the Congress has never had an adequate opportunity to study the LIFO recapture issue and its potential impact on the private sector. The Senate adopted section 403(b) of the Crude Oil Windfall Profit Tax Act without benefit of hearings either before this committee or the Senate Finance Committee. The conferees on the Crude Oil Windfall Profits Tax Act delayed the effective date of LIFO recapture expressly for the purpose of examining the issue. Because of time constraints, however, the 97th Congress has not yet had the opportunity to study this highly technical and complex subject. A one year delay would give the Congress the opportunity to examine and discuss this issue without the distracting pressures of adjournment.

We note that there is increasing support within this committee to defer the effective date. Recently, Congressman William Gradison, prime sponsor of H.R. 5011, drafted a letter to Chairman Daniel Rostenkowski (D-IL) calling for a one year delay in the implementation date. Congressman Gradison's letter has attracted a number of Democratic supporters as well as all of the Republican members of this committee. There is obviously considerable support for deferral among the members of the Ways & Means Committee.

Another significant consideration is that the Congress recently provided for a full and complete study of the methods of tax accounting as part of the Economic

Recovery Tax Act of 1981. That study, scheduled for completion in December 1982, will include an in depth examination of LIFO. It makes a great deal of sense, therefore, to defer the effective date of the LIFO recapture provisions until the results of the Treasury study are known.

Moreover, NAM believes it is likely that the small businessman will bear a disproportionate burden if the LIFO recapture provisions are allowed to go into effect now. It is only recently that many businessmen have become aware of the rapid approach of the December 31, 1981 effective date. Many small businessmen, who often do not have the financial resources to employ highly skilled tax assistance, are unaware of LIFO recapture and its potential impact on their operations. A deferral of the effective date will give businessmen, particularly small businessmen, an additional opportunity to learn of this provision and to plan accordingly.

Finally the proposed one year delay in the effective date probably will result in minimal revenue loss. It is our understanding that potential revenues will be substantially lessened by the fact that some of the larger, more sophisticated corporations have already adopted plans of liquidation as a precautionary measure.

For all of the foregoing reasons NAM supports a one year deferral of the effective date of the LIFO recapture provisions, and urges you to favorably consider H.R. 4717 and H.R. 5011.

NATIONAL ASSOCIATION OF REALTORS,
Washington, D.C., December 5, 1981.

HON. DANIEL ROSTENKOWSKI III,
Chairman, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: On behalf of the National Association of Realtors®, I would like to urge your support for passage of H.R. 5013. This legislation will conform the tax treatment of the Federal National Mortgage Association to that of other financial institutions.

FNMA is an important link between the housing and finance industries. Throughout the past three years of rising interest rates and declines in the housing market, FNMA has continued to borrow money to provide liquidity to the home mortgage market. It has bought mortgages from primary lending institutions so that they can restructure their portfolios and lend more money to homebuyers.

FNMA, like many of the nation's thrift institutions, has been severely battered by this country's recent experience with high and volatile interest rates. The erosion of long-term capital markets has also increased the problems confronting FNMA. Since the asset and debt structure of FNMA is similar to that of thrift institutions, we believe that it is wise policy to tax FNMA as thrift institutions are taxed.

So that FNMA can continue to operate as effectively and efficiently as possible, it is vital that this significant oversight in the tax laws be corrected. FNMA must be permitted to average its losses and gains for tax purposes in the same manner as banks, savings and loans, and other financial institutions, rather than as if they were a manufacturing or retailing company, as is the case at present.

In closing, we want to emphasize that it is not only equitable, but important to the stability of the housing industry to allow FNMA to cope with lengthening periods of high interest rates and inflation in the same way as other financial institutions.

Thank you for your consideration of this matter.

Sincerely,

JULIO S. LAGUARTA, *President.*

NATIONAL SAVINGS AND LOAN LEAGUE,
Washington, D.C., December 7, 1981.

HON. DAN ROSTENKOWSKI,
Chairman, Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The National Savings and Loan League would like to express our support for H.R. 5013, a bill to conform the tax treatment of the Federal National Mortgage Association (FNMA) to that of other financial institutions. We are pleased that you have introduced this important legislation and have scheduled hearings in such a timely fashion.

FNMA is an integral part of the housing finance delivery system in this country. The role of FNMA in housing will grow even greater in the economic environment of the future. It is critical that FNMA be given this tax parity if it is to be able to continue to assist the savings and loan industry and other mortgage finance entities in providing homeownership opportunities.

We urge you and other Members of the Ways and Means Committee to approve this legislation as soon as possible.

Thank you for your consideration of our views.

Sincerely,

JONATHAN LINDLEY,
Executive Vice President.

STATEMENT OF ROBERT L. HADDAD, C.P.A., CHAIRMAN, FEDERAL TAX LEGISLATION COMMITTEE, SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND (SBANE), WALTHAM, MASS.

SUMMARY

1. The LIFO recapture provisions which become effective for plans of liquidation adopted after December 31, 1981 will have a strong negative impact on small businesses. Unlike large businesses that usually sell stock when liquidating and, thus, are not affected by the recapture provisions, most small businesses sell their assets. The magnitude of the LIFO recapture will make it difficult for small businesses to sell assets and liquidate. Therefore, we urge speedy adoption of a measure such as H.R. 4717 or H.R. 5011 which will, at the very least, defer the effective dates of the recapture to at least December 31, 1982.

2. Small business has made and will continue to make a significant contribution to the growth of the economy.

3. The *Thor Power Tool Co.* decision ignores the business realities of obsolescence and slow-moving parts for long-lived assets. Small businessmen need to be relieved from the problems created by *Thor* by means of a more business-oriented approach to inventory accounting. If relief is not provided, we foresee a future shortage on the availability of spare parts.

4. The Internal Revenue Service requirement that taxpayers report inventories on the LIFO basis in their financial statements when that method is elected for tax purposes hinders a small business' ability to borrow capital.

5. Removing the restrictions on the use of the link chain method of computing dollar value LIFO would alleviate the problem many small businesses have with recordkeeping which prevents them from taking advantage of the benefits of LIFO in these times of high inflation.

6. The 80 percent limitation on the use of changes in published indices places small businessmen who cannot avoid the limitation by calculating their own internal index at a competitive disadvantage to larger businesses that can calculate an internal index and are allowed to use 100 percent of it.

STATEMENT

Mr. Chairman and members of this committee: My name is Robert Haddad and I want to thank you for the opportunity to appear before you today. I am a partner with Price Waterhouse & Company, a national C.P.A. firm having financial and tax planning expertise for closely-held businesses.

I am speaking to you today on behalf of the Smaller Business Association of New England (SBANE) and Small Business United (SBU), a coalition of fourteen regional small business organizations that encompasses twenty-five states. Although the primary concern of the Committee today is to address the LIFO inventory recapture provision, I would like to take this opportunity to speak to the need for overall inventory simplification and reform as well.

Competition from foreign countries is increasing sharply while domestic investment and production is declining. Government, businesses and economists realize that there is a critical need to stimulate the growth of the economy. Much of this growth will result from the efforts of small businesses. In order to achieve this goal small businesses need assistance to overcome substantial obstacles, including the continuation of high interest rates (a major problem for small business since they are often undercapitalized), take-over attempts by large corporations, and excessive paperwork created by government overregulation. High interest rates have especially hurt small businesses by reducing after tax earnings below the levels needed to replace inventories whose costs have soared with double digit inflation.

The Economic Recovery Tax Act of 1981 has helped small business with respect to some problems in the inventory area. Changes to the dollar value method of LIFO, allowing the use of a single pool for qualifying small businesses and authorizing the use of published government indices, and provision allowing the restoration of markdowns over three years are certainly helpful. However, the Act falls far short of providing the necessary assistance to small business. Additional changes are needed to mitigate the effect of the *Thor Power Tool* decision, repeal the LIFO conformity rules, simplify the calculation of the LIFO base and index, and eliminate the LIFO recapture provisions of the Windfall Profits Tax Act.

INVENTORY WRITE-DOWNS

The Thor Power Tool Case

In *Thor Power Tool Co.* v. *Commissioner*, the taxpayer wrote down the value of excess inventory on hand to an estimated net realizable value in accordance with generally accepted accounting principles. Upon review, the Internal Revenue Service maintained that write-downs for tax purposes could only be made under the specific requirements of the regulations issued under Internal Revenue Code Section 471. On January 16, 1979, the United States Supreme Court, affirming decisions of the Seventh Circuit and Tax Court, upheld the Internal Revenue Service's disallowance of *Thor's* excess inventory write-downs. The Court held that the method used by *Thor* to write-down the inventory failed to satisfy the requirements of the Section 471 regulations.

The decision rendered by the Supreme Court in *Thor* and the subsequent order of compliance issued by the Internal Revenue Service have caused the small businessmen of America to have nightmares. An example will help to illustrate the problems *Thor* has created for the small businessman:

One of our SBANE members manufacturers industrial sewing machines. This company has been in business for approximately 100 years. The company is very proud of the quality of the machine it manufactures and often points out to prospective customers that many of its machines have been in use for 40 or 50 years. To keep these machines operational, the company must keep spare parts in inventory, or, when it receives a request for a part for an early model machine, it can retool and manufacture the part. If the company must retool to manufacture the part, sound business judgement dictates that extra parts be produced for inventory to cover manufacturing mistakes and future demand.

At the end of the fiscal year the company must value its closing inventory. Included in the physical inventory count are spare bobbins for the 1923 model manufactured by this company. The tag indicates that the parts were manufactured in 1975 when the company retooled to fulfill the request and in the process manufactured an additional twelve bobbins. These bobbins have been carried in inventory at cost for six years, there is little or no demand for them, and under generally accepted accounting principles, the bobbins should be written down to scrap value. But the company must comply with the Supreme Court's decision in the *Thor Power Tool Co.* case and cannot write the bobbins down to scrap unless they are offered for sale at that reduced price. The solution? The small businessman must keep two sets of books: one of financial reporting purposes and one for tax purposes.

The small businessman faces other problems concerning his "excess inventory." By carrying items of this type in inventory at cost, the company is increasing its taxable income each year and paying property tax on these items which may or may not have value. Thus, the tax law is impacting the small businessman's judgement about how he should run his business. He knows that many of his early model machines are still in use and that his spare parts have some value. However, carrying these items in inventory is costing his money.

With the decision in *Thor* which says that write-downs will not be permitted in most cases for FIFO taxpayers, there is a possibility that small businessmen may decide that they can no longer afford to carry spare parts in inventory, resulting in a shortage of parts in the future. The effects of *Thor* must be mitigated. Tax legislation permitting a more business-oriented approach to this problem must be adopted.

The National Association of Wholesale Distributors conducted a survey recently in which all 121 of their national commodity line association members were polled, and which indicated the need for a more business-oriented approach to inventory accounting. In response to the question regarding what changes would be made to comply with the *Thor* decision, 67 percent of the respondents indicated they would retain the affected inventory items for a shorter period or scrap them. The respondents also indicated that they expected these actions to result in higher prices and a reduced number and availability of spare parts.

The problems of obsolescence and slow-moving parts for long-lived assets are real. *Thor* provides a technical legal interpretation of the law and ignores these business realities. It is up to Congress to come to the aid of the small businesses of America and provide relief by means of a more reasonable, rational, business-oriented approach to inventory accounting.

INVENTORY VALUATION—LIFO

Conformity requirements

In determining the cost of goods sold, a sompany can value inventories by using either the First In First Out (FIFO) method or the Last In First Out (LIFO) method of valuing inventories. Under FIFO, the first goods purchased or manufactured are presumed to be the first goods sold, whereas LIFO presumes that the last goods purchased or manufactured are the first goods sold. During inflationary periods, LIFO results in lower taxable income than FIFO, thus matching the most recent, highest costs with current sales.

Recently issued income tax regulations stipulate that the taxpayer's primary financial statements must also reflect inventories on the LIFO basis when that method is elected for tax purposes. Therefore, lower taxable income from the use of LIFO means lower earnings in the taxpayer's financial statements because of the conformity requirements. Non-LIFO information may be provided as a supplement to the primary financial statements with restrictions on the way the information is disclosed and on its content. These restrictions require assistance from accountants and attorneys to insure that the disclosure does not jeopardize the tax benefits of LIFO. This very costly for small businesses which are unable to hire full-time professional personnel to handle these functions.

Small businesses are often under-capitalized and not publicly traded. They must rely on bank financing to obtain capital. Since banks evaluate the operating success of companies based on earnings, small businesses using LIFO are at a disadvantage. This problem has been aggravated by the government's current monetary policy which has reduced the money supply and the availability of financing. In light of this, many small businesses have not elected LIFO because it hurts their chances to borrow by forcing them to reflect lower earnings.

SBU believes that the initial reason for the conformity requirements is no longer relevant. The conformity requirements were enacted with the predecessor of Section 472 of Internal Revenue Code in 1939 to ensure that the LIFO method fonformed to the best accounting practice in the taxpayer's trade or business. It was apparently felt that LIFO was not appropriate for all businesses, and that it could be used only where it could be demonstrated that LIFO was appropriate. This view is supported by the fact that LIFO under the Revenue Act of 1938 was limited to special industries. Generally accepted accounting principles now recognize that LIFO is an appropriate method for all businesses as evidenced by Financial Accounting Standards Board statement No. 33, Financial Reporting and Changing Prices.

SBU recommends that the conformity requirements be eliminated. This would allow more small businesses to elect LIFO and increase internal cash flow.

Valuation of LIFO base

Under IRS regulations, the principal method of computing dollar-value LIFO is the "double extension" method. Under this method each item in ending inventory is extended at both base year costs and current year costs. A base year cost must be ascertained for each new item entering the pool. A simpler method of computing LIFO, called the "link chain" method, is allowed, but only if the taxpayer can demonstrate to the IRS that the double extension method is impractical. As a precondition to using the link chain method, the IRS applies an inventory turnover test on additions and deletions to each item in inventory.

The main difference between the double extension method and the link chain method is the computation of a price index. Under the link chain method only beginning-of-year costs for new items is determined, as compared to the base year cost under the double extension method. The advantage to the link chain method is that it is much easier to establish an item's cost of one year ago than to establish a base year cost which may be several years ago. In order to compute base year costs, historical data must be maintained, and many small businesses do not have sophisticated computer equipment or personnel to reconstruct base year costs.

The elimination of the restrictions on the use of the link chain method would make LIFO calculations simpler and thus more small businesses would elect LIFO.

Simplification of index

Under the Economic Recovery Tax Act of 1981 the IRS is allowed to issue regulations regarding the use of a government index. According to proposed regulations issued prior to the passing of the Act, a taxpayer may elect to determine its LIFO price indices based on either the Bureau of Labor Statistics index, producer price index, or consumer price index. The increase to the taxpayer's index is limited to 80 percent of the increase in the published price index. In passing the law, Congress did not specifically refer to these proposed regulations but indicated the purpose of the new regulation is to simplify LIFO so that more small businesses can obtain the tax benefits. SBU believes that the proposed regulations do not accomplish that purpose.

Corporations may calculate their own index and use 100 percent of the change. Therefore, most large corporations will not choose to use published indices in pricing LIFO inventories because of the 80 percent limitation. Small businesses on the other hand will be limited to 80 percent of the change in published indices. Obviously, the 80 percent limitation places small businesses at a disadvantage and therefore eliminates the benefits of using published indices. Small businesses located in New England are at a disadvantage even without the 80 percent limitation because they are subject to higher inflation due to the dependency on heating and production fuels and their spiraling costs.

In addition, the regulations require taxpayers with sales over $2,000,000 to use different indices for detailed subcategories of inventories. The $2,000,000 limitation is too low as it prevents many small businesses from electing LIFO. Greater simplification of LIFO computations would be achieved if only one index could be used. SBU feels Congress should authorize the IRS to issue regulations specifically limited to small businesses which would allow 100 percent change in published indices and the use of one index for all inventory for companies with under $10 million in gross sales. This would allow more small businesses to elect LIFO and be more competitive with large corporations.

LIFO recapture upon liquidation

The Crude Oil Windfall Profit Tax Act of 1980 contains provisions which affect liquidating corporations that distribute LIFO inventory. Effective for plans of liquidation adopted after December 31, 1981, a corporation which distributes its LIFO inventory in a partial or complete liquidation must recognize the excess of the adjusted basis of the inventory under FIFO over its LIFO adjusted basis as ordinary income, rather than capital gain. It is possible to avoid LIFO recapture if the corporate business will be carried on by new owners and ownership is transferred by selling stock rather than assets.

SBU strongly recommends that the LIFO recapture rules be repealed. We endorse both H.R. 4717 and H.R. 5011 and urge their immediate adoption. A majority of small businesses are closely held, and often sell assets for cash rather than transferring ownership of stock. Usually the corporation is liquidated under Section 337 to avoid double taxation (gain to corporation on sale of assets and gain to shareholder upon liquidation). The magnitude of the LIFO recapture amount in relation to other assets will make it difficult to sell assets for cash. On the other hand, large publicly traded corporations are often sold for stock. Accordingly, the LIFO recapture rules place small businesses at a disadvantage.

It has been our experience that small businesses have recently made business decisions based on tax consequences alone because of the LIFO recapture rules. In one instance a small business has accelerated its liquidation plans to avoid LIFO recapture. In another, a small business transferred its stock to a large corporation rather than sell assets to another small businessmen. These examples demonstrate the damaging effect of the LIFO recapture rules on small businesses. Repeal of the LIFO recapture rules would eliminate the inequity placed on small businesses desiring complete or partial liquidiation.

If repeal cannot be accomplished in the limited time available, we urge the Committee to report favorably a bill to extend the effective date of the recapture provision to no earlier than December 31, 1982 so as to afford the Congress an opportunity to consider an outright repeal measure.

CONCLUSION

The proposals set forth in this statement will reduce obstacles and stimulate growth for small businesses.

For small businesses who decide not to elect LIFO, a more reasonable approach to valuing excess inventory must be allowed. the *Thor* decision will eventually create a

shortage of spare parts as businesses reduce production to avoid excess inventory. Higher prices and unemployment will result from lower production.

In today's economy, the major obstacle for a small business is obtaining financing. The elimination of the LIFO conformity requirements and simplification of the LIFO computations will allow more small businesses to elect LIFO, reduce taxable income, and thus generate greater internal cash flow.

[Telegram]

A. O. *Smith Corp.*,
Milwaukee, Wis., December 8, 1981.

House Ways and Means Committee,
Suite 1102, Longworth Office Building,
Capitol Hill D.C.

Please urge repeal of the LIFO provision which was included in the Windfall Profit Tax Act of 1980.

K. L. CHRISTENSEN, *Tax Manager,*

[Telegram]

SPRINGS MILLS, INC.,
Fort Mills, S.C., December 7, 1981.

Re the scheduled Ways and Means hearings December 8 on LIFO recapture, Springs is and has been for nearly 40 years a major user of LIFO. We are adamantly opposed to this discriminatory recapture and urge its repeal as proposed in H.R. 4678 and H.R. 3606.

Chairman DAN ROSTENKOWSKI,
Rayburn House Office Building,
Washington, D.C.

We can support a deferral, as in H.R. 4717, if time and politics seem to be working against repeal before January 1. But we urge to place priority effort on repeal at the earliest practicable time.

Many thanks for your help.

ROBERT L. THOMPSON, JR.,
Director of Public Affairs.

UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS,
Chicago, Ill., December 3, 1981.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The U.S. League of Savings Associations [1] wishes to express support for H.R. 5013. This legislation would conform the net operating loss (NOL) carryback and carryforward treatment of the Federal National Mortgage Association (FNMA) to that of the other financial institutions serving the important housing industry.

The importance of FNMA to the housing and finance industries is unquestionable. Throughout the past three years of rising interest rates and declines in the housing market, FNMA has continued to borrow money to provide liquidity to the home mortgage market. It buys mortgages from primary lending institutions so that they can restructure their portfolios and lend more money to home buyers. So far in 1981, some 93,000 home mortgage loans were purchased by FNMA with a total value of about $5 billion. FNMA now holds $60 billion in mortgages—one of every 20 homes mortgages in America.

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[1] The U.S. League of Savings Associations has a membership of 4,400 savings and loan associations representing over 99 percent of the assets of the $525 billion savings and loan business. League membership includes all types of associations—Federal and state-chartered, stock and mutual. The principal oficers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; William B. O'Connell, President, Chicago, IL; Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 east Wacker Drive, Chicago, IL 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

FNMA continues its strong commitment to housing in the midst of the worst housing year since 1946. The home building industry is now in its 34th consecutive month of decline with housing starts down from 2,020,000 units in 1978 to a seasonally adjusted annual rate of 937,000 units for the first eight months of this year. With the volume of housing sales down 45 percent since 1978, the entire housing industry, including those who finance it, are in serious trouble.

A principal cause of our disastrous housing situation is the difficulty of our traditional housing lenders to operate in a high interest rate environment. Indeed, the financial institutions, which have long provided mortgage credit for our nation's home builders and owners, have suddenly become the innocent victims of rising costs and low-mortgage portfolio yields. Spurred initially by inflation and then by the government's tight monetary policy to fight inflation, interest rates have continued to remain inordinately high causing great economic dislocation and hardship. High interest rates have crippled FNMA in the same way as our nation's primary mortgage financing institutions, i.e., FNMA's money costs exceed their fixed, low-mortgage portfolio income. With continued instability in the financial marketplace and inevitable high interest periods in the future, FNMA will face additional unrefunded operating losses unless the NOL tax law oversight is corrected.

In recognition of the significant risks and potential losses borne by long-term residential lenders, Congress provided them with a special net operating loss treatment in the Tax Reform Act of 1969. The loss provision was described in the words of the House Ways and Means Committee as "proper protection of the institution and its savers in light of the peculiar risks of long-term lending on residential real estate. . . .". This net operating loss (NOL) provision (10 years carryback, 5 years carryforward) adopted in section 172 of the I.R. Code provided this Congressionally intended protection to long-term mortgage lenders until intervention by the IRS some 10 years later. Then, in 1978, the IRS—without any Congressional or judicial approval—issued a regulation (1.593-6A(b)(5)(vi)) requiring that when a NOL is carried back, the tax base for computation of the savings and loan associations' bad debt reserve allowance in the prior profitable year must be recomputed by the amount of the carryback loss. This change effectively diminishes our tax refund benefit by 40 percent.

Additionally, in 1979, the IRS accelerated the change by providing that recomputation would be required for losses carried back from taxable years beginning in 1979 rather than starting in 1988 as originally proposed. Consequently, at a time when real protection for long-term residential lenders was needed, the IRS substantially underminded by regulation the net operating loss carryback benefits for savings and loan institutions. In view of increasing operating losses by our institutions, the savings and loan business requests your assistance and that of Congress is rescinding this overreaching IRS regulation and restoring our institutions' full NOL as originally intended by the 1969 Tax Reform Act.

However, Mr. Chairman, we want to make it very clear that we fully support FNMA participation in our net operating loss carryback and carryforward treatment, in spite of the fact they will enjoy greater loss carryback benefit (FNMA 100 percent vs. savings and loans 60 percent) than savings and loan institutions.

FNMA is important to the stability and future success of the housing industry and the benefits of IRC section 172 should not be denied or diminished for them or any long-term residential lenders facing their "peculiar", but very real market risks. Therefore, we strongly support the efforts of FNMA to secure as quickly as possible the more favorable loss carryback treatment outlined in H.R. 5013. This action will not only strengthen FNMA's own financial position but will better enable it to survive the up-and-down swings of today's financial cycles.

Sincerely,

WILLIAM B. O'CONNELL, *President.*

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